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STUDY ON MULTIPLE EXCHANGE RATES SYSTEM (MERS) AND DIFFERENTIAL INTEREST RATES POLICY (DIRP)

by

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INTRODUCTION

The African Alternative Framework to Structural Adjustment Programmes for Socio-Economic Recovery and Transformation (AAF-SAP) is an attempt of the Countries of the Continent to formulate a different approach to the International Monetary Fund and World Bank stabilization and structural adjustment programmes which during the 80's those institutions have tried to impose on African countries. The poor results of those programmes, well documented in the exposition made by ECA on AAF-SAP, call for some fresh rethinking and for a formulation of appropriate solutions to the dramatic problems faced by most African countries which have seen a deteriorated situation during the last decade.

As it is said in the Report "the major problems of mass poverty, food shortage, low productivity, weak productive base and back technology that plague Africa are basic bottlenecks that arise from the structure of production, consumption, technology, employment and socio-political organization".

As the report points out, the major policy direction that should be covered are: enhanced production and efficient resource use and domestic resource mobilization, improving human capacity, strengthening the scientific and technological base of the Continent.

No programme implying reduction of production, unemployment, or lesser availability of resources can be tolerated in Africa's present circumstances. International institutions drawing adjustment and stabilization programme's for African Countries should see to it that enough financial help and technical assistance is given to countries to ensure that no reduction in available resources will occur during the period between the implementation of the policy measures until their fruits in terms of production and export growth are obtained.

The purpose of this paper is to study two policy instruments of AAF-SAP in order to show their advantage and disadvantages to African Policy makers. Those instruments are Multiple Exchange Rates (MER) and Differential interest rate policy (DIRP). They will be treated separately as if they were two different papers but it will be no problem in blending both in one single document.

As far as the MER document is concerned, the following topics will be covered.

I. THEORETICAL BASIS FOR MER'S

(A) Orderly classification of MER's and discussion of its

main economic effects.

(B) Other policy instruments closely relate to MER's (advance import deposits and forms of payments).

(C) Relations between MER's and trade and fiscal policies and their trade-offs.

(D) MER's and economic and financial integration.

(E) Evolution of MER's in the last 3 decades and position of the I.M.F. in relation to them.

II. EXPERIENCE OF LATIN AMERICA WITH MER'S

To this effect five countries (Argentina, Brazil, Chile, Paraguay and Uruguay) are discussed in detail for their use of MER's and other related policy instruments. The reasons for their introduction, the evolution they experienced and why they were either total or partially abandoned or substituted by other policy instruments is analyzed. The countries were selected because they made most use of MER's in the region and furthermore because the author is more acquainted with their economic evolution during most of the period.

III. MER'S IN THE CONTEXT OF AAF-SAP

(1) Requirements for a sensible exchange rate system.

(2) What type of MER's could serve purposes in line with AAF-SAP objectives.

(3) Limitations of those advantages.

I. THEORETICAL BASIS AND EFFECTS OF MULTIPLE EXCHANGE RATES[1]

(A) Classification of Mer's and discussion of its main economic effects

In order to discuss economic effects of multiple exchange rates let's design a scheme covering all the possibilities were may have, establishing different exchange rates for groups of exports and imports.

This appears in the following table, where the meaning of the letters is explained, the same as the balance of payments effects of the different possibilities. The discussion follows taking each type of multiple rate and analyzing its economic effects.

Buying Transadine	Selling transactions
e_{x1} V_{x1}	e_{m1} V_{m1}
e_{x2} V_{x2}	e_{m2} V_{m2}
e_{x3} V_{x3}	e_{m3} V_{m3}
$\frac{\Sigma\ e_x\ V_x}{\Sigma\ V_x} = ex$	$\frac{\Sigma\ e_m\ V_m}{\Sigma\ V_m} = e_m$

The signs have the following meaning:

e_x exchange rates for exports
V_x value of exports in foreign currency
e_m exchange rate for imports
V_m value of imports in foreign currency

It is assumed that:

$e_{x1} < e_{x2} < e_{x3}$

$e_{m1} < e_{m2} < e_{m3}$

$-e_x$ average buying exchange rate

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[1] Some of the arguments in this section were taken from a paper written by the author and published in "El Trimestre Económico". Mexico, 1953.

$-e_m$ average selling exchange rate

ΣV_x value of foreign exchange receipts

ΣVm value of foreign exchange expenditures

If $\Sigma V_x = \Sigma V_m$ foreign accounts are in balance

$\Sigma V_x > \Sigma V_m$ balance of payments is in surplus

$\Sigma V_x < \Sigma V_m$ balance payments is in deficit

If $-e_x > -e_m$ exchange system is operated at a loss monetary expansion.

If $-e_x < -e_m$ exchange system is operated at a gain monetary contraction.

This monetary expansion or contraction is independent of the position of the balance of payments. In the first case the government wishes to expand and in the second case to contract the foreign sector.

Even if $-e_x = -e_m$, we can have surpluses or deficits in the balance of payments, and consequently expansion or contraction of the money supply, due to external transactions, the same as if the country were operating with a single exchange rate.

To discuss economic effects of multiple rates we can consider them as taxes or subsidies on certain exports and/or certain imports. To define the tax or the subsidy is necessary to assume and equilibrium exchange rate (without tariffs) where the cost of US$1 worth of imports is US$1 worth or exports. Not even if $-e_x = -e_m$ are we sure that this is the equilibrium rate, but for simplifying the discussion, we may assume that this is the standard which serve us to compare if each rate contains a tax or a subsidy. If $-e_x = -e_m$, as an approximation we shall consider the average of both as the standard of comparison. We shall call the rate of comparison as e.

It is clear also that export and import rates of comparable level can be equal, but are not necessarily so. Thus $e_{x1} = e_{m1}$ or $e_{x1} = e_{m1}$ are both a possibility.

In order to enforce multiple rates it is necessary to have a strict and effective control about the rate applicable to each kind or group of transactions; and that the decision of the authorities issuing the export or import licenses are complied with by the custom authorities. Although multiple rates are a way of introducing principles of market mechanism into foreign

transaction, they cannot avoid the same type of controls as are necessary in the case of quantitative restrictions with a single exchange rate in force.

Of all the forms of multiple exchange rates, we are going to consider:

(a) Existence of a margin (wider than the necessary to pay for the services of exchange dealers) between the buying and the selling rate;

(b) A penalty rate for certain exports ex's < e;

(c) A subsidy rate for certain exports ex's > e;

(d) A subsidy rate for certain imports em's < e; and

(e) A penalty rate for certain imports, em's > e.

In addition to the 5 cases above indicated, it is important to discuss the dual exchange market mechanism, which has been of widespread existence in many Latin American Countries. One market for official, important or basic transactions (with a fixed or adjustable rate) and a parallel market for non official capital and other invisible transactions difficult to control, or that the authorities wish to be controlled through the market mechanism rather than through individual permits or quotas.

(a) Margin between buying and selling rates

(i) External effects

They arise either because buying and selling rates are established at different levels by the authorities or because there is a tax on foreign exchange transactions.

Control over purchases and sales are in this case indispensable, because a market can arise between exporters and importers within the margin in order to evade the tax. Effects of this measures are the same as an ad-valorem tax affecting equally all imports or all exports.

The distribution of the burden of the tax and the effects of the exchange margin over the volume of trade depends on the elasticity of the import demand and of the export supply. If both are great the reduction of trade will be also great; and the burden of the tax will affect more exports if their supply elasticity is smaller than the import demand elasticity. All this, assuming that the tax burden cannot be shifted abroad, because world demand of the country's exports and world supply of the country's imports are

very large.

If export supply or import demand are inelastic, the volume of commerce, will not change much and burden of the tax will distributed in greater or lesser extent among exporters or importers, according to the magnitude of the inelasticity of their supply and demand functions.

If the world offer curve is elastic, the imposition of an exchange spread will improve the terms of trade, but less imports will be obtained with less exports. If the country's welfare improves is not known but the world's welfare as a whole deteriorates. If the offer curve has an infinite elasticity (case most probably for small developing countries), the country cannot change its terms of trade, but only diminish the volume of trade. If the world offer curve is inelastic (absolute value less than 1) the imposition of a spread could not only improve the country's terms of trade but it could obtain a greater amount of imports for the same or less amount of exports. This may be developing countries and more will be said about this in dealing with penalty export rates for some commodities.

The balance of payments effects of the opening of a margin between buying and selling rates can be analyzed in similar form as a devaluation. But there is and important difference because whereas in the latter case the greater cost to the importers is shifted in favour of the exporters, in the case of a margin there is a tax which will be distributed among importers and exporters. Their effect will be similar if the proceeds of the margin are mainly utilized to give subsidies or other stimulus or facilities to all exports or to some of them.

(ii) Internal effects

A reduction of trade, consequence of the exchange spread leads to a less efficient position with factors moving from export industries to industries competing with imports. This transfer will produce a lower level of real income and if factors are specific or if they have low mobility, unemployment may result.

According to traditional trade theory, the exchange spread will diminish relative shares of abundant factors (which it is assumed are used in exports) and will increase the relative share of scarce factors.

(b) Penalty rate for certain exports

Penalty exchange rates on certain products is equivalent to and export tax on them. Its purpose is generally to increase the country's supply of foreign exchange, to obtain more revenues for the government, to impose an additional tax burden on the owners of some industries and to produce an internal redistribution of income.

As not all exports are treated equally, this policy can be considered as a mechanism used by the government to exploit its monopsony power in the exchange markets. The fact is that if foreign exchange supply has different elasticities in different market and if it is possible to separate those markets, the country will gain reducing the price, in local currency which is willing to pay for foreign exchange produced in the less elastic markets. If the internal producers cannot exercise any monopoly power (because they are many) and if the total demand for the products of the industry is inelastic, the government can exercise that power by means of an export tax or a penalty exchange rate. If the internal producers have been exercising that monopoly power in external markets, the penalty exchange rate can transfer monopoly benefits from the industry to the government. And if the industry is in foreign hands that transfer of benefits will result in an increase of foreign exchange revenues for the country.

Both cases above mentioned can be exemplified with penalties rates imposed in Chile on Copper and in Brazil on Coffee. More will be said later about the limitations of those policies.

Also in recent times and in connection with the so called "dutch disease" in certain countries where there is great disparity in efficiency between one industry (oil, for example) and the rest of the economy, the equilibrium single exchange rate in this case can be harmful for the development of other export activities and generally induces a large amount of cheap imports at the expense of local producers. An special penalty rate for the efficient industry could perhaps be an answer to that problem.

Considering the case of the monopolistic exporter, the state can also absorb all the monopolistic profits with a lump sum or a profit tax, which leaves without change the point of maximum profits without changing either prices or quantities produced.

Most of the considerations made about the exchange margin -

which is a penalty rate for all exports - can be repeated with the proviso that in this case the magnitude of the effects will be, in general, smaller.

(c) Subsides exchange rate for certain exports

This exists when the proceeds of certain exports are sold at higher prices (in national currency), than the average or equilibrium rate, e, previously defined. The effect is to give some advantage over other exporters to the producers receiving the subsidy by means of lowering their cost curves.

If there is no change in external demand and no internal inflation, the purpose, of the government could be to alter the composition of export industries but this case is probably of rare occurrence. Perhaps this could be done to support an activity which after a while would be able to stand in equal foot as other exports (argument equivalent to the infant industry protection).

On the other hand internal monetary inflation can raise internal cost, and in this case export industries may be losing ground and not all of them at the same pace. The authorities may feel that a subsidy, equivalent to a partial devaluation of the currency can reestablish the competitive position of the most affected industries. On the whole, proceeding selectively in harmful effects of a general devaluation are reduced.

Finally, without internal inflation foreign demand for some products could be falling due to a depression. In this case the subsidy tends to compensate the lower external prices. Certainly this case makes sense, when the fall in foreign prices is deemed temporary.

A penalty rate with a subsidy rate can also be combined over time to reduce world cyclical movements over export earnings in order to give exporters a more stable level of income.

(d) A subsidy import rate

This rates are granted to a limited number of commodities. When they are given to goods considered essential for the cost of living of the majority of the population, they tend to keep a level of real wages or achieve a certain redistribution of income. Unfortunately, the subsidy is given equally to poor and to rich and in some cases may deter the internal production of those goods, if the country's conditions are suitable for that. Subsidy to sugar imports in Chile delayed establishment of the beet industry and in some cases stimulated the establishment of candy exports, based in the subsidy.

Subsidy exchange rates are given sometimes to the importation of capital goods or for some raw materials and the rationale is to favor economic development or the maintenance of some industries producing goods of mass consumption or given large amounts of employment.

When subsidies are given the exchange has to be rationed and the prices of the goods have to be controlled, because otherwise subsidies will increase profits of producers and intermediaries.

Government transactions, when there are no foreign exchange revenues, are sometimes made at subsidized rates to reduce expenditures in local currencies. Subsidies in those cases have to be financed with penalty rates on other imports or exports; or if the system is run by the Central Bank at a loss, the financing can take place through monetary expansion and inflation.

In some cases, like Chile after the exchange crisis of 1981-82, subsidy rates were given to debtors abroad with the purpose of preventing their total bankruptcy. The burden of the subsidy was assumed by the government.

Effects of subsidy exchange rates for imports on the terms of trade and the balance of payments are the opposite to a raise in import duties. If the subsidy affects only certain imports the results are not different but the magnitude of the effects must be smaller.

(e) Penalty exchange rates for certain imports

Economic effects of this measure is the same as an advaloren custom tariff.

The reason for its imposition can be protection of some local activities, to raise the prices of some luxury which the authorities deem the country can do without, or to obtain additional finance for the government.

When the purpose is to avoid expenditure in luxury items, it is said that the same taxation should affect to the same goods produced locally.

Penalty rates can also finance subsidies given to some exports or to some other imports.

(f) Dual exchange markets

A system of dual exchanges - an official market for basic transactions and a free market for invisibles difficult to control and non official capital movements - as it exist in different countries, may be an appropriate system where undesirable capital movements of large amounts and erratic character may strongly affect basic trade transactions or induce movements in reserves or in the exchange rate, beyond what are the basic economic relations. In order to prevent them the Articles of Agreement of the International Monetary Fund, authorized member countries to impose exchange controls over those movements. But due to the difficulties in controlling capital movement without at the same time controlling current transaction the I.M.F. has authorized in practice dual markets, although in its definition, they constitute multiple currency practices.

The problem of dual markets is that precisely when they fulfill its mission, because the quotation in the free market draws apart from the official rate - assuming this is and equilibrium rate - is when the main problems arise. Under and over invoicing is stimulated, contraband with border countries is incentivated and it becomes difficult to convince the economic agents that the free market quotation is not the "true" or "real" value of foreign exchange and that the government is not following an adequate policy, idea which is reinforced by the generalized tendency of many governments to overvalue the national currency in order to reduce inflationary pressures.

The truth is that dual markets work well, when the free market shows few erratic movements and they are of small magnitude, provided that quotation of foreign currencies is not wide apart in both markets. Exactly then, is when the second market seems to be without justification. However the fact of having a safety valve to face high pressures and the administrative problems of controlling capital movements, make us to think that, despite its problems, dual markets may be useful for developing countries.

But it is wrong to believe that they can induce repatriation of flight capital because that depends on may factors and not only of the level or movements of the exchange rate in the free market. Expectations about future movements of the exchange rate, prices

and interest rates at home and abroad are crucial for those movements. Also political and security factors play a determinant role. What they can do is to reduce outgoing capital movements because of the higher costs of an increasing exchange rate.

(8) Other policy instruments closely related to MFP's

(1) ADVANCE IMPORT DEPOSITS

Many countries in Latin America in addition to multiple currency practices or in lieu of them have used the technique of advance import deposits to check selectively the demand for imports. If the rate of deposits over the value of imports and the period during which they are required to be held are the same for all imports the check is not selective and the measure is equivalent to open a spread between the buying the selling rate of foreign exchange (which is defined by the I.M.F. as a form of multiple exchange rates) or to impose an even tax or surcharges on all imports.

Import deposits are generally required to be held at the Central Bank, and the importer or depositor is not paid any interest, thus resulting an additional cost for the importation (over the price of foreign exchange and the custom duties).

Advance import deposits can be visualized as a monetary measure decreasing or expanding the monetary base and therefore the possibility of credit creation, or as a exchange restrictive measure (a form of multiple exchange rate) and as such the I.M.F. has considered that those measures fall under its jurisdiction.

Some countries in the past (i.e. Ecuador) have used non discriminatory advance import deposits to check an excessive demand for imports, due to an exogenous shock or perhaps to a temporary increase in domestic credit in cases where the medium or long term level of the exchange rate was not in doubt. In such cases small percentages of advance deposits or even the requirement of advance payment of the whole or part of the custom duties, had a contractionary effect on the money supply and could check an excess demand for imports. It is essential of this measure that the monetary authorities do not offset its effects expanding credit in order to allow the financing of the deposits. In his sense the establishment of the deposits, for small countries without well developed financial markets, can be considered similar to an open market sale and the reduction or abolishment of the deposits, as an open market purchase.

The measure produces an once and for all effect, unless the percentage of deposit, or the time period to be held or the value of imports change. Open market operations are not different in

this respect, but they do differ in the time period in which they produce its full effects, being the time for advance deposits much longer and its effects more gradual as in the case of open market purchases and sales.

Another difference and this may be in favour of establishing advance deposits in developing economics is that even if they affect all expenditures - as a monetary contraction or expansion in general - they affect primarily expenditures on imports. An in as much as the contraction of the money supply affects nominal incomes and therefore prices and/or costs, it could induce an expansion of exports. If the rate of deposits are differentiated, according to the type of transaction, the authorities then attempt to affect not only the level but also the composition of expenditures abroad. Here we face the question if neutrality of the measures is a virtue which the authorities should maintain, or if they should influence expenditure decisions in order to attain certain political social or development goals.

In general, in most cases in Latin America, in recent decades, where advance import deposits have been established, the objective has been to reduce the level and/or to affect the structure of imports. In this sense, the authorities have looked at advance deposits as an alternative to devaluation or to multiple exchange rates or as a reinforcement of those measures in similar directions.

The restrictive effects of advance import deposits are not very large, unless the percentage or the time period of the deposits is fixed at very high levels.

If we impose an advance deposit at 100% of the import value for a time period of 90 days and the interest rate (alternative cost of money) is 20% per annum then the cost for the importer is 5% of the value of imports. If the demands for imports is strong, the restrictive effect of that cost cannot be very important. It is possible for the deposit to be more restrictive than an import surcharge or tax of an amount equivalent to the cost of the deposit, due to the difficulties of obtaining large amounts of financing but in general one has to keep in mind that importers are a preferred group to the banks because lit to them implies n addition to the loan business, the gains of the import and exchange transactions which are linked to it.

One objection made to advance import deposits is that the additional payment made by the importers in providing deposits free of interests accrue to the suppliers of financing which generally are bankers or foreign suppliers. On the other hand, surcharges or taxes for an equivalent amount to the cost of deposits will accrue permanently to the government. However, for a given amount

of permitted credit expansion the restrictive impact of import deposits leaves room for credit expansion to whatever purpose the government may find desirable. And if the beneficiary is the government, this can obtain from the Central Bank an amount of resources greater than the cost of deposits, because of the assumption that governments do not repay debts to the Central Banks (those revenues can take the form of seignorage or an inflation tax).

The opposite problem presents itself when deposits are released; the amount of resources that flow to the economy (even if the release is gradual) jeopardizes the possibilities of financing to other sectors of the economic without an excessive expansion of the supply of money and the creation or the increment of inflationary pressures.

People in the government, Central Bank, importers and bankers always prefer advance deposits to a strong devaluation. They feel the process may be less costly and some of them may profit as e.g. the bankers. On the other hand the I.M.F. is much more lenient with advance deposits than with multiple exchange rates. In may cases it has accepted the establishment of deposits as a substitute for the elimination of multiple rates. However the Fund looks upon the deposits as a transitory measure and whenever possible exercises pressure (perhaps in connection with a stabilization program) for the elimination of the deposits and the reflection of its costs in a more realistic exchange rate.

Advance deposits are not suitable to be imposed on in visible transactions, except on invisible related to imports. Neither are they generally imposed on capital transactions; although some countries to prevent an excessive inflow of funds on certain condition (short term foreign loans) have imposed the keeping of a certain % of the loan as a short of reserve requirement, being the time period of the deposit longer for shorter period loans (perhaps excepting commercial loans with original maturities of 1 year or less). This was the case of Chile during the 70's Ecuador at the beginning of the oil era (after 1973) imposed taxes on short term loans, which had the same purpose as the measure previously mentioned in the case of Chile. In Brazil at present (1988), foreign loans are subject to mandatory deposits at the Central Bank. In any event A.I.D. had smaller coverage than multiple exchange rates. the global effects of this difference will much depend on the structure of the balance of payments of any given country.

Advance import deposits are biased against exports, where multiple exchange rates can be constructed - at least in theory - in a way as transferring the additional cost of imports in more favourable rates for all or for some exports.

All what has been said about MER in the sense of having an able and honest set of officials to qualify transactions according to regulations and to coordinate this action with the custom houses in order to ensure that goods cleared are the ones to which the rate in force applies or for which the amount of required deposits has been made. However, from the experience of countries with multiple rates and advance import deposits it appears that enforcement is easier in the case of deposits than in case of multiple rates, particularly when there is a big spread among them.

(2) PAYMENT CONDITIONS

As soon as the balance of payment sis in clear disequilibrium and foreign exchange reserve assets decline up to a point of being almost negligible for any useful intervention in the exchange markets, the authorities are faced with the dilemma of either adopt measures to redress the external situation (all of them are painful because they imply to reduce expenditures and increase production, i.e. more effort and less satisfaction) or to postpone the adjustment trying to borrow abroad. Sources of foreign funds can rapidly be exhausted and the countries may use different policy instrument to face the scarcity of foreign exchange. All of them are well known: to prohibit some imports; to ration foreign exchange; to give priority to essential payments; to enter into barter or bilateral payment agreements which do not require use of foreign exchange; to devalue the national currency either in an uniform way or to do it selectively through the establishment of different types of exchange for groups or classes of transactions. Advance import deposits can also serve the same purpose, but at any given time when payments problems are insurmountable, payments arrears start to develop.

Multiple exchange rates and advanced import deposits are dealt with in other sections of this paper. Here we will refer briefly the so called "payment conditions" (formas de pago).

Payment conditions are forms of settlements of obligations abroad by which the debtor country unilaterally imposes conditions of payments which are not negotiated with foreign suppliers but which they can accept or reject. Examples of payments conditions are the following.

(1) No cover of exchange is allowed for imports until a certain period (120 to 180 days) has elapsed since the shipment of goods.

(2) Capital goods or spare parts can be imported for at least 80% of its value with credits over 5 or 8 years. No payment over 5 or 10 per cent of its value can be made

before the shipment of goods.

(3) Advance payments of certain periods have to be made on certain exports, generally goods for which the country has strong foreign markets or which are scarce in supply.

In all those cases the country tries to save exchange or to get anticipated proceeds from its exports, on the assumption that its external problems are of a temporary nature and that forced foreign borrowing can tide the country over from its difficulties.

Foreign suppliers can acquiesce to those conditions. In general, if they are eager to sell, they will do it, but generally they would charge higher prices to compensate for the delay in payments.

In the case of capital goods or of some consumer's durables, the regulation on payments conditions may well confirm the conditions on which the suppliers are willing to provide their goods. Government schemes to promote exports sometimes allow for insurance of export credits, but when the economic conditions of the acquiring country have deteriorated, it may well be that no insurance is granted or that the premium will be raised.

If foreign exporters are not in agreement with the payments conditions, they may require the opening of an irrevocable letter of credit before the shipment of goods, and if they are essential, this procedure can void the regulations established by the purchasing countries.

Payments conditions, although very generalized in many Latin American countries, cannot be interpreted as equivalent to multiple currency practices, because if the credit is granted to the importing country, this has to pay a compensation - equivalent to an interest - in the form of higher prices, and because the suppliers are always free to accept or reject the conditions established by the authorities of the importing country.

But in fact, regulations on minimum credit conditions facilities the obtention of payments conditions which by means of individual bargaining will be probably harder to obtain.

The International Monetary Fund has declared that payments arrears for which the Central Bank has received from local importers counterpart funds, without payment of interest, are a multiple currency practice, under the jurisdiction of the Fund.

Moreover, the Fund in granting stand-by credits has required the elimination of payments arrears and import prohibitions as soon as it is feasible or within certain defined time periods. In many

cases also new credits obtained by the country as a consequence of the stand-by with the Fund are applied to the elimination of arrears.

(C) MULTIPLE RATES, TRADE AND FISCAL POLICIES. (TRADE OFF)

(a) Trade Policies

There is no possibility of distinguishing economic effects of multiple rates and a corresponding system of taxes and subsidies over international transactions. Same principles about custom duties apply in this case.

There are, however, some institutional differences.

(1) Custom duties, taxes and subsidies affect generally commodity trade, whereas multiple rates apply to all international transactions.

Services and transactions in assets could be taxed and subsidized out of the exchange system, but this is more difficult to make and generally is not done.

(2) Custom duties are subject to international commitments and treaties in most countries; and cannot be changed by unilateral action. Different exchange rates can be established and modified with more facility. Except for the fact that they are under the surveillance of the I.M.F.

(3) Custom duties, taxes and subsidies on international transactions, in most countries require laws to be established, modified or abolished. On the other hand, multiple rates can be set up by administrative action; in most cases Central Bank action. Therefore , they are easy to establish to modify and to eliminate.

(4) Multiple rates are more difficult to understand and they hide to the public their character of taxes and/or subsidies. Therefore they are less resisted by public opinion.

(5) Custom duties are a component of normal fiscal revenues. Profits form a system of multiple rates (if they exist) go generally to the Central Bank. In some countries a large part of Central Bank profits go to the Government. But control on expenditures of the Central Bank, generally is not the same as control of budget expenditures.

Therefore they can be used for purposes different than the ordinary budget. And if the exchange system gives losses, they are generally not financed out of the budget, but result in a monetary expansion.

(6) Custom duties have generally a permanent character or at least greater stability than multiple rates, which are considered as established with a transitory character.

(b) Fiscal Policies

Being equivalent to taxes and subsidies, multiple exchange rates have important effects on public finances.

We have seen that on the whole the exchange system can produce net revenues or net losses. In both cases, although the latter one is more infrequent, the government has to decide what to do with the proceeds or how to finance the deficit.

There are cases where the International Monetary Fund has recommended - as a temporary devise - the establishment of a spread between the buying and the selling rate, in favour of the government, in order to mop up a large fiscal deficit, until expenditure reductions or new taxes could be put in place.

But, in general, multiple rates are so devised that on balance do not result in big changes in the position of the fiscal budget.

There are cases in which a penalty rate on some exports (like the case of copper owned by foreign companies) was used to obtain permanent revenues for the government and more foreign exchange for the countries. Perhaps other cases similar to that (on oil or tin) could be quoted.

Penalty rate on luxury imports could have the same character but except for automobiles where special taxes or tariff duties have been mostly used - the revenue resulting from luxury penalty rates is not high and generally does not cover the cost of subsidies to some other exports and/or imports.

General consideration of fiscal effects of multiple rates can be made in the same direction as of custom duties in the sense of being indirect taxes (today they are not the great sinners they once were) and by the fact that they affect the efficient allocation of resources.

Some people are of the view that if certain activities should be taxed or subsidized, because of the existence of social negative or positive externalities, this should be done explicitly through the budget, approved by Parliament and with a clear knowledge of public opinion.

This is all right from a theoretical point of view, but there are some considerations which without invalidating the above

mentioned proposition, give some practical support to the idea of taxing and/or subsidizing in an indirect or biased way:

(a) Legislation may be difficult or impossible to obtain, therefore the only alternative is to renounce to a policy which may have positive results;

(b) Direct granting of subsidies have the appearance of giving undeserved gifts, on the other hand, price changes through special rates of exchange, give to the beneficiary the idea that he is obtaining something deserved and not a gift. This may be important for the moral and the economic behavior of the agent. It is his effort what is rewarded.

(f) Multiple exchange rates and economic and financial integration

One of the objectives of AAF-SAP to incentivate economic integration of the Continent and "strengthening intra-African monetary and financial cooperation as well as payments and clearing arrangements".

Multiple currency practices of different sort in each African country will not facilitate financial integration. It would be clearly and impediment. the moment African countries find themselves in a stage similar to the one European countries are at this moment. But as long as they engage only in a process of reducing barriers to trade or to establish industries which can cater to different African Countries in order to take advantage of the economies of scale, multiple exchange rates of different structure should not be and impediment to achieve that goal.

If there is a payments and clearing arrangement among a group of countries, having MER's transactions have to be carried in an agreed unit of value. It can be accounting US dollars, ECU's, DEG's or whatever unit which can express itself in the currencies of the different countries encompassing the clearing arrangement. The exporters of each commodity will receive in his own currency the amount established by the corresponding exchange rate and the importers will pay for the unit of account the rates which the authorities will establish for the transaction. The clearing will take place among Central Banks in unit of accounts which may be converted or not into other currencies, according to the agreements in force.

One problem presents itself, when the exchange system provides for free market rates for some transactions (e.g. tourism or capital movements). It seems that those transactions should be left out of the clearing. However, it is possible to construct schemes by which, for example, intra countries tourism or business

travelling could be channeled through the clearing. Free market operations have to be realized in the currencies agreed upon by the transactions.

In order to facilitate multilateral payments settlements when one or more of the participating countries has multiple exchange rates, all countries in the system should respect and to reinforce in their territories the exchange regulations of all members.

(E) Evolution of MER's in the last three decades and position of the I.M.F. in relation to them[2]

The Fund's Articles of Agreement prohibit member countries to engage directly or through its fiscal agencies in any discriminatory currency arrangements or multiple currency practice, except as authorized or approved by the Fund. Such practice may involve the existence of separate exchange markets, the application of exchange rate taxes or subsidies, inadequate payments of interest on advance import deposits and counterpart deposits against payments arrears, significant exchange rate spreads between buying and selling rates for spot transactions and broken cross rates. The Fund approves multiple currency practices only when a well conceived plan is in place to bring about their elimination or substantial simplification during a relatively short period of time. In many instances, the staff assists the authorities in formulating such a plan, usually in the use of Fund resources.

In April 1984 and February 1985, the Executive Board reviewed the Fund's experience and policies with respect to multiple exchange rate regimes. In the context of a discussion in early 1985 of multiple currency practices applicable solely to capital transactions, the Executive Board did not adopt a view on the question of Fund jurisdiction over these practices, leaving the matter for further consideration..." "The experience the Fund membership with regard to practices that segment foreign exchange markets precisely on the basis of current and capital transactions has been limited: Very few countries have multiple currency practices that segment foreign exchange markets precisely on the basis of current and capital transactions; very few countries have multiple currency practices that are identified as relating solely

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[2] International Monetary Fund. Exchange Arrangements & Exchange Restrictions, Annual Reports corresponding to 1985, 1986 and 1988.

to capital transactions.[3] In most of these instances, these practices have not taken the from of a separate exchange rate for capital account and they have served as an adjunct, and not as an alternative to quantitative controls on other forms of capital transactions. Furthermore the spreads have generally been maintained at a more or less steady depreciated rate over extended periods of time, have varied mainly in response to non-balance of payments factors, or have been subject to infrequent discretionary changes all of which indicate that these practices have played a limited "buffering" role for variations in capital movements.

According to the Fund, in the middle of the 50's about two thirds of member countries, representing one third of world trade had such practices.

At the end of the 50's and early 60's a substantial simplification of multiple rate practices occurred. This was due in part to the fact that most industrial countries declared the external convertibility of their currencies and also to an improvement of the world trade situation; the simplification took place in both developed and developing countries.

Thereafter there were times in which the use of MER increased as in the late 60's and again in the early 80's this last period coupled with the exchange and foreign debt crisis affecting most developing countries.

There are, according to the Fund, a number of reasons for this happening:

(a) As an alternative to straight devaluation which was viewed as too costly from a political or social perspective;

(b) In response to volatility of capital flows or more frequently to one way (outward) pressures of the capital account;

(c) Preferential rates were set up for debt service with the aim of alleviating the financial position of certain industries which were faced with liabilities in foreign currency after a substantial devaluation of the national currency has occurred.

In spite the fact that after near 40 years of fight against MER as an instrument of policy they still appear in an open or disguised way in a great number of countries and they do it

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[3] Certain types of capital transactions (e.g. short term banking facilities, amortization on depreciation of foreign investments) are defined as current international transactions under the Fund's Article XXX

apparently according to the cycles in the balance of the payments, the Fund always raises the same known criticisms about them:

(1) MER tend to become a long-lasting aspect of member's exchange arrangements.

(2) They did not produce the desired effects or produced them at a high economic cost. They could induce black market operations or prevent the expansion of some lines of production r stimulated over consumption... Coupled with quantitative restrictions produce monopoly gains to the importers without favouring domestic consumers.

(3) When the system is introduced as a "buffer" for capital speculation, the spread between the free and the official market raised doubts about the continued viability of the official market.

(4) MER are subject to numerous modifications over time.

(5) In short, MER are costly in terms of efficiency and in resource allocation and have not proven conducive to medium term balance or payments adjustment.

The trend towards increase in MER at the beginning of the 80's was reversed in 1984. Then 6 members simplified and 6 introduced or interssified their MER systems. In 1985 there was a decline in the use of MER. In nine countries they were simplified; and in 10 countries were incroduced. The trend started in 1985 was continued until 1987 in the sense of reduced reliance on MER.

The Board of the Fund has reaffirmed recently (1985) its views on MER.

Fund policies in the area of Multiple Exchange Rates should remain flexible, pragmatic and responsive to each country's particular circumstances. The most important judgement to be made when declining on the approval of multiple exchange rates systems relate to their temporary character.

The position of the I.M.F. on MER is in the least flexible and pragmatic. The articles of agreement in giving the Fund authority to approve those practices, implicitly were recognizing that some of them (because one has to recognize that they are many) or in certain circumstances could be necessary for the country and not harmful for the international community. In stating that the approval is given only when there is program for its elimination, the Fund is denying a possibility contemplated in the Articles of Agreement.

The Fund may be right in its general criticisms on MER but most of them is based in a world of perfect markets, reasonable stability and open economies, a world somewhat distant from the real world where countries in some circumstances may be forced to take actions which are second best solutions.

Probably outside the case quoted, when the Fund accepted a margin between buying and selling exchange rates, as temporary device to reinforce fiscal revenues, in no other case, the Fund has recommended the introduction of any form of MER.

Given the facts and policies of the I.M.F. this is factor that developing countries have to take into account in formulating their policies if they are seeking financial support from the international community.

I.M.F. position on many issues is not immovable. To a very large extent it depends on the ideologies and views of the American Administration. Those are liable to change. If African and other developing countries representative made reasonable proposal in the Boards of the Fund and the Bank and if there are a certain mutual support of other countries (mostly developing) there are chances that if not all at least some of their views are accepted. To some extent a few things have been obtained in the past (See, for example, the 1981 stand-by given by the I.M.F. to India). But to achieve that is necessary not only the solidarity already mentioned but the ability of the developing countries representatives and superior staff, and that their allegiance will be to the countries they belong and represent and not to the Institutions where they work.

I. EXPERIENCIA OF LATIN AMERICA WITH MER'S

Multiple rates - or equivalent devices - have been widely used in Latin America after the war and they still are in effect in many countries. However the great multiplicity of rates practiced in Brazil and some other southern countries of the Continent have virtually disappeared.

They were imposed because the official parity was not sufficient to contain import demand and because it was thought that a devaluation would give to exporters benefits difficult to explain. For this reason when many countries dismantled their multiple rate system, at the same time established export taxes or retention of exchange in order to minimize the effect of the devaluation on the export industries.

Straight devaluation was generally objected on grounds of stimulating inflation because it increased export revenues and raised the price of all imports. At the same time price of other

traded goods were equally affected.

Deflation did not appear as solution politically feasible and its effects are slowly produced. Its application required the existence of a certain amount of foreign exchange reserves to finance the excess of imports until the income contraction produces a reduction of import demand. At the same time if prices and costs are not flexible and labour lacks mobility unemployment may ensue.

Quantitative restrictions are effective to eliminate the deficit and reduce imports selectively, but to be economically positive they require an efficient and honest administration with clear knowledge of the country's needs and must be complemented with internal rationing and price controls. Otherwise they become a source of monopolistic gains for the importers who get the licenses. The experience in Latin America in this respect has been negative. Multiple exchange rates attempt to introduce a market mechanism and try to avoid direct controls. But this is true only when the imports are allowed at a penalty exchange rate. For subsidy rates the fact of excess demand forces also the application of some rationing and price controls. Penalty exports rates also need control, the same as subsidy rates.

According to a Latin American economist and central banker,[1] the most common failure in the application of MER's has been to try to include the greater part of imports at the preferential rates and to impose higher rates only to a small amounts of luxury items. A system like this is not restrictive enough to suppress excessive imports. Furthermore, if the export rate is kept much below the free rate (when inflation has pushed that rate well over the official rate), exports will be discourage, their proceeds will be shifted to the free or black market and the scarcity of exchange will become more dramatic.

According to this author despite its disadvantages MER's adequately applied can be a remedy, but a short run remedy, to exchange problems in Latin America. However, for the long run they not appear as a solution for the financial an economic problems of the region. Latin American countries need a more efficient use of national resources, increase savings and more help from foreign capital.

As soon as a MER's system is established there is a tendency to make it more complicated. Pressure on the part of exporters and importers to open new rates, or to include its goods at the preferent established rates, are more difficult to resist. The

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[1] Felipe Pazos "Sistema de cambios múltiples". Paper presented to the 1948 meeting of the American Economic Association.

tendency arises to make the system more cumbersome, difficult to administer and subject to red tape. In order to create a more rational system of allocation, exchange budgets are drawn and importers are assigned exchange quotas on basis of past performance. This system is an hindrance to adapt the distribution of foreign exchange to changes in tastes, new goods and new technologies. Very easily, also, corruption becomes a feature of the MER's system.

When in the 60's most Latin American Countries eliminated or at least simplified their MER system, to a large extent they were moved by the existence of the problems above mentioned. But also a great influence was exercised by policies of the I.M.F. against multiple rates. The hope to get foreign finance, not only I.M.F. balance of payments finance, but also development finance induced many governments to revise its position in relation to their exchange systems.

Remember that the Alliance for Progress, introduced by President Kennedy in the 60's to counteract the influence of Castro's Cuba in the continent, was a system combining internal reforms and foreign assistance to foster development. But among the requirements to be entitled to the Alliance financial help, countries had to enter agreements with the I.M.F. to ensure that their stabilization, balance of payments and exchange policies were right. Among the requirements of those agreements were the elimination or gradual simplification of multiple exchange rates.

In the following a review is made of 5 countries in Latin America, Chile, Argentina, Brazil, Paraguay and Uruguay. There we can see the multitude of instruments which were used, the time of their simplification and when they were reestablished it happened in a more simplified way. An attempt has been also made to pinpoint some of the main economic event which gave rise to different policies along time.

ARGENTINA

During de war Argentina, which sided to some extent with the Axis powers, accumulated a great amount of foreign exchange and engaged in lavish expenditures when peace came, as nationalization of railroads and other public utilities all of which became a heavy burden to the government. The country was not invited to participate and during the first Perón government (1945-55) was not a member of the newly created financial institutions, the International Monetary Fund and the World Bank.

In the early 1950's a large reduction in export proceeds (due to a severe draught) added to the difficulties due to the exhaustation of foreign reserves and the country's financial isolation. Since the time of the depression, Argentina had developed exchange controls and an extensive net of bilateral payments agreements. Reduction of fiscal revenues and inflation added to the balance of payments problems and the authorities tried to minimize the effects of a necessary devaluation, setting up a complex system of exchange rates which was rather similar in all neighboring countries.

In 1958 and 1959 the new authorities, after the fall of Perón, tried to follow the recipes of the I.M.F. which officers of that institution judged as being a big success. The 1960 Report on Exchange Restrictions said quite optimistically "In several countries, the reduction in the use of multiple currency practices has been achieved by replacing complex systems with a single rate. Those countries which during the last few years have substituted single exchange rates for complex multiple systems had, in general, satisfactory experiences with their new exchange system during 1959, and most of them were able to strengthen their international reserves. In Argentina, the single fluctuating rate was maintained, with a tendency to stability toward the end of the year. The authorities eliminated advance deposits for imports and some export taxes and reduced the special import taxes introduced at the time of the exchange reform."[1]

As of 1960, in Argentina imports were free of licensing and exchange to pay for them was obtained in the free market. Approval by the Central Bank was required for capital equipment imports by official agencies if payment was extended over a period of more than 180 days.

Surcharges on the c.i.f. value of imports were payable before

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[1] I. M.F. Report of exchange Restrictions, 1960. Pages 4-5.

customs clearance, as follows:

List 1 (fuels, and some other essential capital goods): no surcharge.

List 2 (numerous raw materials, drugs, and other goods): 20%

List 3 (semi-processed articles, lumber, chemical products, etc.): 40%

List 4 (spare parts, tires, tools, etc.): 100%

List 5 (Luxuries, musical instruments, etc.): 150% plus a temporary surcharge of 50%.

List 6 (certain industrial machines and motors similar to those produced locally): 100% or 150%, depending upon essentiality.

List 7 (items to be announced) 200%.

All imports not specifically included in these lists were subject to a 150% surcharge, plus a temporary surcharge of 50%, except that imports of automobiles were subject to a special surcharge which varied with the weight of the automobile. exemption from surcharges were granted to some imports.

Payments for invisibles could be made freely thorough the free market.

Exports were free of direct control and the surrender of exchange proceeds was not required. The principal export products were subject to retention taxes calculated on the basis of export prices by the Office of the Secretary of the Treasury. The amounts retained were 10% for wool and most meat and 20% for cereals, oil-seeds, vegetable oils, quebracho extract, hides, and certain livestock by-products.

Exchange derived from invisibles could be sold without restriction in the free market.

Inward and outward capital transfers by residents or nonresidents were free. The corresponding exchange transactions were settled through the free market.

IN 1961, the system described for 1960 was basically maintained. But after a years the country was again in financial difficulties, partly due to external circumstances, but also because there was a lack of continuity in policies due to rapid changes in governments and the two different approaches prevailing

in economic policies.

(a) one called "desarrollista" trying to follow expansionary policies and state intervention at all costs; and

(b) the "monetarists" believing that financial stability and an open economy were the basis for sound and sustained development. On the other hand, the peronista movement and its support among the main labour unions never lost strength until they came back to power in 1973 to implant populist and in some cases very ill conceived policies. By 1976 the military were again in power and with different heads of state pursued orthodox policies the same as its neighbors, Chile and Uruguay.

Argentina, the same as other important countries in Latin America received great amounts of medium and large term commercial foreign bank loans to support its balance of payments. It seems that a large portion of those loans was placed by Argentina residents abroad. Therefore little investment took place to expand the economy and create new jobs and foreign exchange to service the debt.

The Malvinas Islands war with Britain produced the collapse of the military regime and a new democratic President, Dr. Raul Alfonsin was elected (1983-89). He was not able to solve the country's financial problems and handed his government to his successor before the end of his period in the midst of a financial chaos.

As of the end of 1987, Argentina operated a dual exchange market: An official for trade, public and some capital transactions with the rate for the austral (Argentina currency) announced daily by the Central Bank. All other transactions were conducted through a freely fluctuating market determined rate.

In addition to customs duties, imports were subject to a stamp duty and selective taxes ranging from 3 to 22 per cent. Certain imports were subject to a special import surcharge of 15 per cent.

Some imports were prohibited and some others were subject to an elaborated system of licensing which varied according to the category of goods, such as consumer and inputs for which close substitutes were amply available in Argentina, other intermediate and most Capital Goods etc.

Most imports are subject to minimum financing terms of at least 180 days, calculated from the day of shipment. There are some exceptions for goods coming from integration zones of Latin America where that term is reduced or payment is permitted against shipping documents.

in domestic and foreign bank notes.

Capital transactions (loans and its service as well as foreign investment and repatriation of profits) are subject to extensive regulations and laws (for more details see the annex).

BRAZIL

Brazil after the war attempted to implement policies of economic and regional development* without giving too much attention to the external resources constraints. Coffee, cocoa, and cotton, its main exports presented at times weak markets and Brazil had relied heavily on medium term suppliers credits, the services of which compounded the burden on the balance of payments of its expansive policies. A moderate inflation was thought by authorities and businessmen to be good for economic development. To avoid a general devaluation a complex system of multiple exchange rates was established. Already in the early 50's the country had serious difficulties in servicing its debt, was incurring in large payments arrears (which increased the cost and delayed the reception if its imports) and the debt with foreign suppliers had to be reprogrammed in the early 50's within the so called "Hague Club".

By 1960, the I.M.F. Report on exchange Restrictions stated, underlining the progress made in elimination of multiple currency practices, that "In four other countries they were simplified somewhat, but they continue to be complex. In Brazil, the number of export rates was reduced by moving more commodities to the free market". And in 1961 (March) the fund noted that Brazil instituted important changes in its exchange system. The <u>auctioning of exchange</u> was abolished and imports in the General and the <u>Special</u> Category had to be obtained in he free exchange market. Special category imports, however, required import licenses which were auctioned on the basis of global quotas. Importers may not acquire in any one week exchange exceeding US$20,000. A new exchange rate of Cr. $200 pr U.S. dollar, instead of Cr. $100 , was applied to payment of preferential imports (e.g. petroleum, wheat and newsprint) and to outward financial transfers previously subject to the preferential rate. Fore exports sold in the free market, Cr. $100 of each U.S. dollar was paid to the exporter in the form of 120 day bills of the Bank of Brazil.

Imports at the time (end of 1959) were made according to the following rules.

1. Specified commodities <u>for which payment is not made through the auction system</u>. In this group are specified government imports; wheat, petroleum and derivatives and capital goods

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* A program for the Northeast, part of extreme poverty and the foundation of Brasilia as a new capital to open the interior of the country. The project was already well advanced in the early 60's.

considered essential for development, or national security. These imports were subject to a surcharge (as of Dec. 1959 of Cr. $81.08 per US$1) fixed periodically by SUMOC (Superintendency of Money and Credit), based upon "the cost of exchange" the weighted average of bonuses paid to exporters, plus the official exchange rate. Government imports not considered essential for economic development or security were subject to a surcharge no less than the weighted average of actual bids in the related auction category. Imports of newsprint by printers whose publications weigh 80 grams or less were paid at the official rate plus a special charge periodically adjusted. Exchange for all these imports was allocated in the exchange budget approved by SUMOC.

2. All other imports were subject to a purchase of exchange certificates at auction. For allocating exchange in accordance to essentiality, these imports were classified in two categories.

(1) General category: Raw materials, production goods and consumer's goods whose internal supply was not satisfactory; and

(2) Special category: Other goods.

As a rule an importer could not purchase more than US$50,000 worth of exchange certificates at any single auction.

Invisibles related to exports were made at the same rate as the goods exported. Freight and insurance payments incidental to imports were made at the free market rate. Payments for other invisibles were made through the free market. Travellers could take out domestic and foreign currency notes freely.

All exports were subject to license.

Exports subject to the official rate were classified in two categories for each of which a bonus had been established:

(1) coffee and cocoa Cr. $57,64 (effective rate, Cr. $76,00);

(2) cocoa derivatives, castor beans and crude mineral oil: Cr. $81,64 (effective rate, Cr. $100.000).

Export proceeds negotiable at the official rate have to be turned, through a commercial bank, to the Bank of Brazil. The proceeds of other exports had to be surrendered to an authorized bank at the fluctuating free market rate, but immediate payment in cash was made only for Cr $130 per US$, the difference was paid in notes of the Bank of Brazil with 6 months maturity and 6% of annual interest.

Exchange proceeds from most invisibles were sold through the free market.

The inflow and, with certain exceptions, the outflow of foreign investment could take place at the market rate. There were special regulations for some capital transactions and foreign investments.

The following table summarizes the different buying and selling rates existing in Brazil at the end of 1959. Buying rates ranged from Cr. $ 18,50 to the dollar up to Cr. $ 198.00 which was the level of the free market fluctuating rate. And selling rates ranged from Cr. $ 51,35 per dollar to Cr. $443 - 46 which added to the free market rate, the auction premium for the import license for US dollars (120 days) at the end of 1959.

Table of Exchange Rates (as at December 31, 1959)

(cruzeiros per U.S. dollar)

Buying	Selling
18.36 (Official Rate) 18,50 (Parity Rate) Government and other receipts 76,00 (Official Rate plus Cr$57,64 Bonus) First Category exports	18,92 (Official Rate) 51,35 (Official Rate plus 40% of Cr$ 81,08 Surcharge) Imports of newsprint by printers whose publications weigh 80 grams or less.
100,00 (Official Rate plus Cr$ 81.64 Bonus) Second Category exports	100,00 (Official Rate plus Cr$81,08 Surcharge) Government payments. Preferential imports, including specified government imports, wheat, imports for the petroleum and printing industries, petroleum and petroleum derivatives, etc. Imports of newsprint by printers whose publications weigh more than 80 grams. Amortization and interest on registered loans, credits, and financing.
198,00 (Fluctuating Free Market Rate)	203.00 (Fluctuating Free Market Rate)

All other exports. Most invisibles. All incoming capital	Most invisibles. All capital transactions not effected at preferential rates.
	213.32-219.93 (Official Rate plus Cr.$424-427 Auction Premium) General Category imports.
	44[illegible]-445.92 (Official Rate plus Cr.$424-427 Auction Premium) Special category imports.

During 1960, there was little change in the multiple rates except that the premium for special category imports went up by about 60% as can be seen in the following table.

Table of exchange rates (as of Dec. 31, 1960)

Buying	Selling
18.36 (official Rate)	18.92 (Official Rate)
18.50 (Parity Rate) Government and other official receipts	
90.00 (Official Rate plus Cr.$71.64 Bonus) First Category exports	67.67 (Official Rate plus 60%) of Cr.$81.08 Surcharge) Imports of newsprint by printers whose publications weigh 80 grams or less.
100.00 (Official Rate plus Cr$81.64 Bonus) Second Category exports	100.00 (Official Rate plus Cr.$81.08 Surcharge) Government payments. Preferential imports, including specified government imports, wheat, imports for the petroleum and printing industries, petroleum and petroleum derivatives, etc. Imports of newsprint by printers whose publication weigh more than 80 grams. Amortization and interest on registered loans, credits, and financing.

181.40-199.10 (Fluctuating Free Market Rate) All other exports. Most invisibles. All incoming capital

186.40-204.10 (Fluctuating Free Market Rate) Most invisibles. All capital transactions not effected at preferential rates.

226.92 (Official rate plus Auction Premium) General Category imports.

639.92 (Official Rate plus Auction Premium) Special Category imports.

After 1961, the auction system was eliminated in Brazil and a more simplified system was put into force, but the same features of taxing main raw materials traditionally exported and giving subsidies to some cost of living and other essential imports and servicing of the foreign debt was maintained. Since 1968 Brazil adopted a system of small changes in the "Bank of Brazil Free Market rate" which was the main factor for an spectacular growth of exports of untraditional, mainly industrial goods, in the decade prior to the first oil shock. In the following years the accumulation of reserves was very great, actually greater than programmed. Economic growth proceeded at very high rates, between 1968-70 at 9-10 per cent per year, and over 11 per cent in 1973. Industrial growth was even higher (around 11-16 per cent per annum). During this period industry and commerce increased their share in the G.D.P. at expense of the agricultural sector. Within the industrial sector capital goods and consumer's durable goods reached the higher rates of growth, meanwhile consumer non durable increased at much lower rates. In summary agreements with the I.M.F. (1965-72) with the purpose of simplifying and liberalizing the exchange system had very low impact in the rate of growth of Brazil to which the authorities put the main emphasis even at the cost of higher inflation. To tackle the latter they adopted gradualist policies, and indexation of basic variables even at the cost of having higher price increases than desirable.

Brazil suffered very strongly the effects of the oil price increases, but during a long period up to 1982 was able to borrow from the international banks considerable sums of money which added to exorbitant interest rates and to world economic stagnation produced the unfavorable economic and financial conditions affecting the country in recent years. Lack of adequate policies have turned the situation worse.

Table of Exchange Rates (as at March 5, 1964
(cruzeiros per U.S. dollar)

Buying	Selling
600 ("Special" Market Rate) Exports of coffee, sugar, and [petroleum	620 ("Special" Market Rate) Imports of wheat, petroleum and petroleum derivatives, parts and accessories for the use of Petrobras, and newsprint; servicing of Brazilian Foreign Debt, government commitments to Eximbank, IMF, Brazilian Treasury Delegation in N.Y., loans with gold guarantees, and similar government commitments.
1,100 (Bank of Brazil Free Market Rate) Receipts not negotiated at "special" market rate and offered to Bank of Brazil.	1,140 (Bank of Brazil Free Market Rate). Payments through Bank of Brazil for selected transactions.
1,190 (Authorized Banks' Free Market Rate less 15%) Exports of cocoa beans and cocoa paste against convertible currencies.	
1,330 (Authorized Banks' Fee Market Rate less 5%) Exports of cocoa derivatives against convertible currencies.	
1,400 (Authorized Banks' Free Market Rate) Receipts not negotiated at "special" market rate.	1,450 (Authorized Banks' Free Market Rate) Payments not negotiated at "special" market rate.
1,450 (Fluctuating Rate) Foreign banknotes and incoming travellers checks.	1,480 (Fluctuating Rate) Foreign banknotes.

At present (1988) most imports and exports in Brazil. are subject to 2 approval of official authorities (CACEX)[7] which are authorized to levy a processing fee up to 0.9% of the value of the import certificate.

To grant the import license is necessary that importers arrange external financing with specified minimum maturities for the type of commodity and the amount of imports involved. some imports, including direct imports by public administration bodies are exempt from this requirement.

Cacex may approve applications for payment of imports of any goods at terms of up to 360 days from the date of shipment without authorization of the Central Bank; financing terms on excess of 360 days have to be evaluated by the Central Bank in the light of foreign debt policy. Prior to shipment of goods, total payment to suppliers for non financed amount of imports may not exceed 10 per cent of the import value.

The Foreign Investment Law governs payments for current invisibles, royalties, technical assistance and income from foreign capital.

Remittances on income from foreign investment are subject to an especial law and interest on loans are subject to a withholding tax on income at a rate of 25 per cent or other determined by agreements between Brazil and other countries to avoid double taxation.

Purchasers of foreign exchange for a number of current invisibles are subject to the financial transactions tax of 25 per cent.

Exports require an export certificate issued by Cacex. some exports require prior approval by Cacex, some other are prohibited or suspended or are conditional on prior domestic sales. Exports of coffee are authorized by IBC (Brazilian Institute of Coffee). They are authorized at minimum registration prices (in US$ a pound. f.o.b.) fixed periodically for the various types of coffee, although discounts are also authorized.

Coffee exports are subject to a contribution quota at a rate that is changed regularly by IBC, depending on market prices. The quota can be paid in two equal installment, one at the time of registration and the other one day after the coffee is shipped.

A number of export incentives are in operation. Some

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[7] Foreign Trade Department of the Banco do Brasil (S.A.).

manufactures are eligible for tax credits. For a number of exports to the U.S.A. export taxes from 0,6 - 27,4 per cent are levied: and for ladies footwear to all destinations a tax of 2,2 per cent is levied. In 1987 export taxes at different rates were levied on a number of products irrespective of destination.

Various financing, programs for exports some at preferential exchange rates, are provided. The facilities include financing of production and warehousing. Assistance is also provided to exporters by means of credit insurance and guarantees.

Proceeds from invisibles can be sold at the free market exchange rate and travellers may freely bring in domestic and foreign currency notes.

Capital inflows, remittance of profits and borrowing abroad are subject to detailed regulations. Foreign loans are subject to mandatory deposit at the Central Bank. In the case of private enterprises the deposit is applicable to 75 per cent of the loans proceeds converted into cruzados (name of the national currency) and they are released, according to a certain schedule.

The National Monetary Council imposes quantitative limits on the amount of financial loans for which authorization may be given by the Central Bank. As of the end of 1986 the minimum acceptable maturity was set at seven years.

CHILE

At the start of the depression (1912) Chile abandoned the gold standard and engaged in a protectionist foreign trade policy and in domestic expansion to reduce unemployment. Although the rate of exchange against the dollar was depreciated, the country kept for several years two basic exchange rates. One called official which at the beginning, applied to a few transaction, but with time it was the rate at which foreign companies exporters of copper, nitrates, iodine and iron had to surrender foreign exchange to pay for their local cost of production and taxes. That rate was kept at a value of Pesos 19,37 per dollar until the middle of the 1950;s. In as much as the country during this period, was undergoing a process of continuous price increases and (average or equilibrium) exchange rate depreciation, the difference between the foreign companies rate and the normal rate was widening and thus revenues in foreign exchange for the government were evergrowing.

The second rate, referred above, called "free" rate was at a time moving around pesos 25 per dollar but finally settled at 31 pesos, quotation which could be kept until after the end of the war (1947). The stability of that rate can be explained by the conservative monetary policies pursued by the government between 1933 and 1939 and by the fact that during the war (stable and a little higher copper prices) and the impossibility of importing from industrial countries produced surpluses in the balance of payments which were applied to the formation of a "new gold reserve".

During the period 1947-1955 inflation and exchange rate depreciation gained momentum. But, in general, depreciation of the rate was made in order to minimize its effects on the internal economy, insure supply of basic goods at reasonable prices and incentivate exports which could not have been made at a general or average rate of exchange. At the same time the special rate for big foreign owned mineral exporters was maintained.

An idea of the complexity of the rates can be seen in the following table stating the exchange rates for the years 1949-50.

Chile's export and import rates, 1948-50
(Chil $ per US$)

	Export rates	1948	1949	1950
1.	Copper, Nitrates & Iron (foreign companies)		19.37	19.37
2.	Sulphur	31.00	43.20	60.00
3.	Wool	35.84	37.00	49.85
4.	Barley	27.00	43.00	60.00
5.	Beans	38.28	41.20	60.00
6.	Industrial & others	39.00	39.40	60.00
	Import rates		% of imports made	
7.	25 Chil $ per US$	22	1	-
	31 " "	33	28	28
	43 " "	55	71	13
	50 " "			59
Approximate average rate		37	44	50
Free market rate		60	77	73

Source: International Monetary Fund, Reports on Chile.

Chile entered a number of payments agreements during this period (mainly with Argentina, Brazil, Peru) and some special bilateral arrangements allowing the country to place nitrates (a declining industry) in some countries. Due to the fact that those balances were in general not entitled to settlement in hard currencies, the unit of account (US dollar) in the agreement was sometimes quoted at values differing from the American currency (contrary to stipulations in the bilateral agreements).

During the period of relative stability of the exchange system (1934-47) the same general rate for trade (31 pesos to the dollar) was also applied to invisibles and capital. But when the system became more complex and the trade (and other official or related to trade transactions) rate was not free to move but kept by the authorities at certain levels, an unofficial free makes arose outside the banks, which although not legal was in practice tolerated and used for tourism, and other invisible trade and capital not officially authorized at banking rates.

By the middle of 1955 the inflationary process was getting out

hand (with dangerous social movements) and traders were highly unsatisfied with the complex system of multiple rates and restrictions, plagued with arbitrary decisions and even corruption. The government decided, then to engage the services of an American consultant firm with the support of the I.M.F. and an implicit offer of a large stabilization loan, to undertake, among others, the reform of the exchange system. All quantitative restrictions and multiple currency practices were eliminated. Trade and trade related transactions were conducted by a supposedly freemarket (in fact it was fixed and changed by the Central bank). Imports were allowed in any amounts from a very restrictive permitted list and, according to categories, were subject to different percentages of advance import deposits in pesos which had to be held at the Central Bank for some time periods.

All other transactions could take place in a second market where only occasionally Central Bank intervention took place.

The system was subject to many changes in later years due to numerous exchange crisis (there were changes in the list, pegging of the rate, reintroduction of quantitative restrictions, changes in the percentages of import deposits, establishment and abolition of import surcharges introduction and abolition of terms of payments arrears in import payments, etc.) but the system as it was established in 1955 is basically the same as to day.

In 1961, for example most imports were subject to either an advance deposit or a surcharge. Some were exempted. Surcharges, ranging (in 6 categories) from 5 to 200 per cent of the CIF value and payable in U.S. dollars were charged a number of imports. Advance import deposits were applied to most imports not subject to surcharge. Deposits could be changed from time to time and were divided in 8 categories.

(A) 5% of CIF value of imports during 30 days;

(B) 20% of value during 30 days;

(C) 50% of value during 30 days;

(D) 100% of value during 30 or 90 days, according to the type of goods;

(E) 200% of deposit for 90 days;

(F) 400% of deposit for 90 days;

(H) 1000% of deposit for 90 days;

(J) (All goods not on the permitted list) 1500% value of

imports for 30 days.

Advance import deposits at times had to be made in US$ denorinated governments bonds and for category A in cash..

In the middle 60's advance import deposits were eliminated and substituted in its cost equivalent by surcharges.

At the beginning of the 70's they were reintroduced (in very high rates which the Central Bank could waive in specific cases) as an instrument for direct control over imports. Most trade during those years was conducted by State owned enterprises or corporations.

Exports were freely allowed with a few exceptions and exporters had to sell their exchange proceeds in the market for trade transactions with the exception of large foreign mining companies which had to surrender only the equivalent of their local costs of production and taxes.

After 1975 a unification of markets and elimination of surcharges and import deposits took place. This was parallel to a reduction of custom ducies to an even 10% on all imports (except automobiles). Up to 1979 the exchange rates was adjusted in short periods, according to the strength of domestic inflation, but from 1970 to 1982 the rate was pegged. No parallel, of black market arose, this was just the period of big inflow of foreign commercial bank loans, which stopped in 1982 and triggered an exchange crisis. After experimenting with different systems, since 1985 the peso rate have been pegged to the US dollar and adjusted at daily intervals, according to a schedule based on domestic less estimated foreign inflation in the previous month. Banks and foreign exchange dealers.

On December 1985 the rate was at Ch $ 180,22 per dollar. Two years afterwards it was at Chil. $ 234,05 and at present (Oct. 1989) it is near Chil $ 280.

Banks and foreign exchange dealers can trade foreign exchange at any price but the Central Bank intervenes when the upper or lower limit (of ± 3 per cent of the official rate)[a] is reached."

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[a] This is as of December 31, 1987.

Direct transactions in foreign exchange rates, provided they are occasional and unpublicized.[3] The difference between this parallel market and the official rate has been rather small for some time (5-10 per cent), but during this year it has widened up to 15 per cent.

At the time of the exchange crises some debtors abroad on debts contracted prior to August 1982 were given a subsidy, of Chil. 72,69 per dollar at the end of 1987 (31% of the official value of the dollar). The subsidy was paid in notes indexed to inflation and carrying a 3 per cent interest.

Most imports are subject to a 120 day minimum finance requirement since March 1983 and imports on credit exceeding 360 days require Central Bank authorization.

After several changes in the tariff after 1983, since January 1988 a uniform tariff rate of 15 per cent is applicable to all goods.

All commodities may be freely exported but the proceeds have to be surrendered to a commercial bank within certain periods.

Payments for invisibles sometimes require Central Bank authorization and in other cases they are subject to certain limits. Proceeds from invisibles must be surrendered when required by legal provision.

Capital inflows are generally free, but most outflows are restricted, except through the parallel market. All new foreign borrowings or refinancing requires prior approval of the CEntral Bank.

There are several arrangements for foreign capital to enter the country and remittances of amortization and profits are subject to special provisions.

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[3] This is an understatement because there is a tolerated parallel market publicized every day in the newspapers.

PARAGUAY

This country suffered from an extended and bloody war with Bolivia up to the end of the 30's. Before in the XIX century it had been reduced in territory and population by a war against Brazil, Argentina and Uruguay. In the 40's the political situation was chaotic and poverty generalized. In the middle of the 50's a strong man, general Stroessner, came to power and was a dictator ruling with iron fist for near 40 years. During the early years of his government he was inspired by Argentina's dictator Juan Perón policies and was unable to stop inflation and to simplify a very complex exchange system and a net of bilateral payments agreements to conduct trade. The fall of Perón (1955) put in jeopardy the future of his regime, Paraguay being up to then a landlocked country very dependent on Argentina whims and policies. Stroessner decided to make a turnabout approaching her neighbor Brazil as a balancing force and requesting help from the United States and the International Monetary Fund, both granting some help to back financial reforms.

By 1958 Paraguay got rid of most of its exchange restrictions and bilateral agreements and leaving a single floating exchange rate in order to obtain its market level and to be stabilized later on.

Fiscal budget was balanced and Central Bank money creation was limited. As most of Paraguay's economic activities were agricultural and most of the few industries were catering foreign markets, stabilization had little effect on production and employment. Internal prices started to move in very low percentages and the guarani could keep a stable quotation to the dollar for many years.

Notwithstanding the system kept in an indirect way many of the practices which the reform was supposed to get rid of

By the year 1960 no licensing were imposed on imports. But imports were subject to advance deposits according to essentiality of the merchandise from 0 to 300% and they were retained from 120 to 180 days.

Some essential goods were exempted from deposits (wheat, government imports). Equally exempted were importers whose imports were not financed by bank credit and who held proceeds in US dollar. However 46% of such exports had to finance imports of some specific investment goods.

Exports were subjected to small taxes in guaranies and invisibles and capital were free to move in either direction.

In 1961 some commodities considered luxuries (automobiles, whisky, etc.) were temporarily prohibited. The advance deposit system was somewhat reshuffled, and four surcharges of 5 per cent each were set-up on imports from countries other than Brazil, Bolivia, Argentina and Uruguay. Some specified imports (from international agencies, or imports of wheat or oil were exempted of one or of all of surcharges).

Approval of the Central Bank was required on imports with credits of more than 3 months and certain commodities were subject to export licensing in order to maintain domestic supplies.

Political and financial stability ensured in Paraguay a steady but modest growth during several years when inflation was under control and the exchange rate rather stable. It kept the value of 126 guaranies to the dollar from 1959 to 1979.

An important turnabout of events came with the exploitation of big electric power projects jointly with Brazil. Paraguay became an exporter of electricity to neighboring countries and could experience over a decade one of the highest rates of growth in Latin America.

During the period of 1974-79 big inflows of capital allowed an increase of 2½ times the value of imports. After a small decline in 1983, they reached over US$1.000 million in 1987 (In 1972 they were less than US$80 million).

In recent year the Paraguayan system became somewhat more complicated.

As of the end of 1985 the exchange arrangement consists of four rates, three of which are fixed by the Central Bank, while the fourth, which is operated by banks and exchange houses, fluctuates freely.

(1) An exchange rate of ₲ 160 per US$ 1 applies to transactions related to the binational entities and to public sector capital and external debt service payments.

(2) A rate of ₲ 240 per dollar applies to 50 per cent of exports at minimum prices, registered capital transactions, imports of petroleum, fuel oil and agricultural and industrial inputs.

(3) A rate of ₲ 400 per US$ 1 is applied for the remaining 50% of proceeds from exports at minimum export prices.

(4) All other transactions (i.e. most non oil import payments, profit remittances, and private service payments are channeled through the free exchange market, which at the end of

1985 showed a rate of $ 650 to the US dollar.

There are also a number of taxes, at different (generally small percentages) on purchases and sales of exchange, making for different effective rates.

Some imports require authorization. The Central Bank operates a register of importers with 4 categories of priority for import goods. All imports are subject to a minimum financing of 120 days.

Surcharges calculated on the c.i.f. value are payable on most imports up to a maximum of 30 per cent.

Imports of a few commodities are prohibited and imports on credit require Central Bank authorization which is normally granted for machinery and other capital goods.

Some exports are prohibited and some are subject to annual quotas. In all exports, the central Bank establishes minimum export prices denominated in U.S. dollars which marks the minimum to be surrendered by each exporter.

URUGUAY

Import protection for agricultural goods in the developed countries (specially Europe) made the situation of Uruguayan exports difficult for wool (where they have to face the competition of Australia, New Zealand and of the new introduced artificial fibers) and for beef. The country faced inflation, the official exchange rate (which could not be changed without Parliament approval) was not accepted by the Fund and became soon overvalued. A complex system of multiple rates was introduced, in order to limit imports to the country's capacity to pay and to encourage new exports. among them, a favourable rate was set up for wool tops[18] which gave to this industry a more favourable treatment than to raw wool exporters and which enabled Uruguayan exporters to invade the market up to then in the hands of european producers. A conflict was created between Uruguay and influential members of the Board, which prevented the country to establish a par value, to pay its subscription to the Fund and to use the institution resources. the conflict lasted several years but finally a settlement was reached.

At the beginning of 1961 the par value of Uruguay was Pesos 7,40 = US$1, but all exchange transactions took place in a free market with a fluctuating rate. Most exports were subject to "detracciones" (taxes) and most imports were subjects to surcharges. At the end of 1960 the free market rate was Ur.$11 per US$1.

Imports were classified in 4 categories. One was not subject to surcharge; while the other three were subject to surchardes of 40,75 or 150 per cent. For imports liable to surcharges in the highest category an advance deposit of 100 per cent was also required. For some goods it had to be kept in the Bank of the Republic for 9 months and for a few items and goods not listed, the deposit had to be maintained 12 months.

In Uruguay, at the beginning of the 60's, proceeds of most exports were subject to "detracciones" (taxes) which were withheld by the Bank of the Republic. For some commodities the detraction (tax) was stipulated by pesos per unit of export comodity; but it could not be more than 50 per cent or less than 5 per cent of the peso proceeds of the export, except that for exports of greasy wool the stipulated minimum was 25 per cent. These percentages may be adjusted at 60 day intervals.

Invisible and capital transactions could take place freely in the fluctuating free market.

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[18] A process of cleaning crude wool to reach a more advanced stage of industrialization.

In 1961 reports (1961) that several countries in the Western Hemisphere had offset the fall in world prices depreciating the exchange rates to maintain the local currency revenues for exports, like Uruguay for wool.

Uruguay experienced in the following decades many changes in the exchange system and a strong inflation not know to the country in the past. During the military regime it was influenced by liberal and open policies like Argentina and specially Chile.

The new civil government has kept the exchange system under reasonably modified features. Although many of the gimmicks used in the past are maintained in a simplified way.

The monetary unit of Uruguay (end of 1987) was the new peso; its value in foreign exchange was determined by market forces; although the Central Bank (established in the 70's) had the right to intervene to buy and sell in disorderly conditions in the market. As of October 1987 buying and selling exchange rates to the dollar were N$ 0.0281 and N$ 0.0285. There is a small tax on sales of foreign exchange.

All imports were subject to registration (valid for 180 days) and to prior deposit subject to import surcharges ranging from 10 to 45 per cent of the value of goods. There are exceptions to imports coming from ALADI (Latin American integration association) and for certain specified selected commodities. A consular charge of 2 per cent is collected by the Bank of the Republic on the f.o.b. value of certain imports.

Customs tariff rates vary between 0 and 15 per cent and there is a service charge of 1 per cent. The combined effect of all charges on imports (including tariffs) is limited to a maximum of 45 per cent. Import surcharges are calculated on an officially assessed price (precio de referencia) or on actual c.i.f. value, whichever is higher.

Export proceeds must be sold to the banks not later than 30 months after the expiration of shipping documents.

Exports are eligible to rebates in respect to indirect taxes levied during the productive process.

Traditional exports as meat, greasy wool, hides and livestock on the hoof, are subject to an export tax at the rate of 5 per cent. Fish exports are eligible to tax credit certificates amounting to between 2 per cent and 3 per cent of the value of exports.

Invisibles (payments and proceeds) can be made freely and the latter have not the obligation to be surrendered.

Inward and outward capital transfers, by either residents or non residents may be made freely with the exception of certain transfers relating to investments registered under the Foreign Investment Law.

There is no doubt that Uruguay has made since the middle 50's a tremendous progress in simplifying the exchange system and reducing the scope of many restriction. However in lower percentages these have been kept to serve similar purposes as the old regime of multiple rates. However it can be said that some of the surcharges and taxes (or at least a certain amount of them) are serving the purpose of reinforcing fiscal revenues.

III. MMRS'S IN THE CONTEXT OF AAF-SAP

(1) Requirements for a sensible exchange rate system

There is not a unique answer to this question. experience show that different systems may serve well the needs of a country. And perhaps with some exaggeration one could say that all systems are good, provided they are well managed and that the country's policies are right, i.e. conductive to stability and development. But when those premises fail, there is a tendency to ascribe the failures to the system and to think that a reform or a transformation of the same will put things right.

Remember the Bretton Woods system and how well it worked up to the middle of the 60's. The failure was not due to the system, but to the policies of some important members, particularly de U.S. Economists and policy makers believed in the early 70's that a free rate system will put off the strains of fixed exchange rates and create leeway to countries to pursue their own domestic policies and aims. No one is satisfied with the floating, except perhaps the United States, and major countries in Europe have chosen an Area of exchange stability which conducts a large part of their trade.

One thing which could be important in this matter, is for the country to adjust itself as much as possible to what has been its tradition on the subject. Particularly during times in which the

exchange system has operated with reasonably smoothness.

A second aspect is to set up a system as simple as possible. And if some departures appear to be warranted, to limit them to the minimum and provided that their need is clearly established.

Simplicity of he exchange system has the advantage that the exchange rate stands out as the important variable which it is. This has become more necessary in as much as most economies are largely dependent on other economies and the foreign sector has been acquiring a growing importance not only in trade but also in capital transactions and loans. Economic agents are at an advantage if the exchange rate (or the average of rates) signalizes what activities should be stablished for exports and what goods would be more conveniently acquired abroad. The same, in combination with interest rates, and expectations of changes in exchange and interest rates is true in connection to investments and finances.

This could lead to two orthodox solutions: one is a single fixed exchange rate, and the other is a single, floating exchange rate, determined by the forces of the market. Both solutions, conforming to textbook theories, are not appropriated for most developing countries. Probably they are not either for developed ones.

The first alternative is the model of the gold standard or of the Bretton Woods System in its earlier years. Most developing countries could not maintain the system, unless they were satisfied with a rather low rate of growth, determined mainly by the medium term increase in their exports. Violent cyclical movements in export earnings, aggravated with procyclical capital movements, leads to dramatic balance of payments crisis and the introduction of unorthodox corrective measures. Developing countries do not have the diversity and flexibility of their economic structure to adapt themselves to large external shocks. They do not have the sensitive instrument, as the English Bank rate, which could induce offsetting capital movements during the XIX century; nor have they the facility of the United States to borrow substantial amounts abroad to avoid the painful process of adjusting its external deficits.

Flexible or free single rates are not either a solution because they create a greater instability, jeopardize any policies to control inflationary pressures and in the medium term, the lead to a greater devaluation (lower than equilibrium exchange rates) due to the fact that in developing countries there is a one way tendency to place capital abroad and those outflows of capital are possible only with exchange rates below equilibrium which will create the current account surpluses (or also reduce the deficit)

necessary for those outflows to materialize.

Developing countries, specially when they are shown a certain degree of instability or when they are prone to have that instability need to have exchange systems and exchange rates managed by the Government or the Central Bank.

The fact that the exchange system should be managed does not imply that it has to be cumbersome, complicated, subject to many bureaucratic procedures, red tape, etc. Even managed, the system should be as simple as possible, natural without leaving aside the country's economic objectives and taken into account the quantity and the quality of officials which the country could utilize.

Assuming for the moment, the existence of a single rate of exchange (or a single official rate with a parallel free market for capital transactions and invisible difficult to control) the level of that rate should be such that in a medium term equilibrates the balance of payments (considering grants, soft loans, etc.). That rate should be kept constant in real terms, adjusting its nominal values by changes in costs and prices at home and abroad. Rates which overvalue our own currency are inimical to development: they prevent the expansion of the most efficient industries which can cater foreign market and are a poor defense of local activities which may have an healthy development and compete with imports. as it is difficult to assess exactly the amounts of changes required in the nominal rate is better to place it rather in the high side of the value of foreign exchange if the country tries to incentivate her exports. But it is also necessary avoid undervaluation of the currency because in that case the country starts to give for nothing its labor and natural resources.

The technique used to keep stable the real value of the exchange rate and the intervention currency are not very important. But I think preferable to make small adjustment in the nominal rate at short periods of time and select an intervention currency which belongs to a country with which the developing economy has most of its trade and financial relations. Another alternative could be to select a basket of currencies, like the DEG, the ECU or any other. This has the advantage that in a world of fluctuating rates among the principal currencies, a basket or a composite has more stability than any of its components.

If there is a group (it may well be very large) of transactions taken place at official rate or rates of exchange and at the same time there are transactions excluded from that market, a black market will emerge. this will be also the case if the rate overvalues the domestic currency and the balance of payments is equilibrated with quantitative restrictions; or if the economy and the forces of the market are such that should lead to a rate in

which the domestic currency is clearly undervalued and the authorities resist those forces.

In all those cases a parallel free and legal market is a better alternative than a black market. experience has shown that illegal markets cannot be avoided and is better to have an organized market run by banks, exchange houses, or other corporations about which the authorities can have guarantees about their financial soundness and at least some statistical control.

Having said a few things about the main features of an exchange system appropriated not only for Africa but also for other developing countries, we are going to indicate which ones of the multiple rates already discussed could serve some of the purposes of AAF-SAP.

(2) What types of MER's could serve purposes in line with AAF-SAP objectives

(1) Dural market mechanisms from the discussion of the rest of the paper seem more suitable and better than other alternatives to control capital movements and some uncontrollable invisibles.

One alternative is to close the eyes and prohibit some transactions: they produce black markets. the other alternative is devalue the currency to an extent which may not have justification in light of the prevalent basic conditions at home and abroad.

The difficulties the I.M.F. expresses about the non existence of clear cut situations between current and capital transactions arises from the fact that this clear-cut dichotomy does not exist. many capital transactions take place through current transactions. And capital inflows or outflows can take place only by imbalances in the current account of the balance of payments.

But for the authorities is perfectly clear to determine what belongs to the official market: trade, invisibles related to trade, official payments and receipts, official loans and investments and their services, profits and amortization. There are border lines like insurance, banking services, and royalties which can be put in one side or in the other and the rest of the transactions should be eligible for the free market.

(2) Penalty rates for some exports which have to be considered in conjunction with export taxes as an alternative. Limitations of this practice will be shown in the next section.

This practice could be constructed as a penalty and subsidy rate, over time, according to the cycle position of the commodities

in foreign markets. An alternative would be to tax profits in the boom phase of the cycle and to give a subsidy in the depression phase. This could be done if the profits of the industry accrue to the Government or to private producers.

Penalty rates as it was shown in the theoretical section are more reasonable when the demand for the affected exports is inelastic, and particularly when the country can exercise a monopoly power which individual producers (by the fact of being many) cannot exercise. If the industries are foreign owned, the penalty rate can entail a shift of profits to the government and a greater supply of foreign exchange from these industries to the country.

This type of arrangement should be studied when a group of countries are producing a similar commodity for exports and the increase in quantities exported will lead to lower revenues (inelastic demand). Policies in this case should be coordinated or perhaps this would be a case for the establishment of a scheme of stabilization with participation of all producers (as it was the case of coffee, for example).

(3) Subsidy rate to some exports ex > e.

If we assume that e is an equilibrium rate, this policy could have justification only in the case of and infant industry which needs a temporary support. It does not mean that the exchange system is the best instrument to develop new export activities. The State should have and use for that purpose many instruments: tax rebates, credit in favourable conditions, insurance for export credit, technical assistance, information about markets and products which may be placed abroad, participation in international fairs, international agreements and representations to foreign countries in GATT and other fora of the obstacles which may encounter African product, etc.

(4) Subsidy import rate. This measure has very little economic justification and it can be explained only as a very temporary device in order to reduce the effects of a necessary devaluation on the price of some essential goods or cost of living commodities. For the reasons which will be seen in next section, those subsidy rates should be eliminated as soon as feasible. They can be replaced by more efficient instruments.

(5) Penalty rates for some imports. These are generally luxury imports for which there may be a great domestic demand by well-to-do groups which are not essential for the basic needs of the population. If the goods are not internally produced (automobiles, TV. sets, and other electronic equipment) a penalty exchange rate or an import surcharge or a special custom duty could

be justified. But domestic luxury consumption should be equally taxed.

(6) A spread between the buying and selling rates could have justification to create revenues for the government. But as a permanent device it would appear better to have an across the board tax on all imports, or on all exports. The difference of the exchange spread is that it affects also invisible trade and capital transactions. Its coverage is larger.

(3) Limitations of the use of MER's

The opposition of the I.M.F. to the use of MER's is something which have to be evaluated by African countries as a group or individually in order to design a strategy for the acceptance of those MER's which they deem necessary for the prosecution of their economic aims and which cannot be replaced by other measures or can be replaced only with great difficulties. Evaluation has to be made in the light of the financial packages which may available counting with I.M.F. collaboration.

A second limitation comes from the need of having an able and honest body of public servants in position to administer the system and to exercise the necessary controls for the public welfare.

Now coming to the specific measures outlined in the previous section, we will make some additional comments.

(1) Dual market mechanisms have not great problems when there is a small spread (let's say 5% or less) between the markets. But when the system needs to serve as "buffer" to capital flights, the margin gets wider. Then the exporters will underinvoice to sell exchange in the free market, "illegal" border trade or "contraband" will increase in one direction or the other according to relative changes in the level of foreign exchange markets in both border countries.

Also some doubts about the validity of the official rate will arise. People psychologically will believe that "the real" value of foreign exchange is the free market value and the IMF may pressure for additional or larger devaluations in the official market in order to reduce the spread. This will occur even if the official market is in line with basic economic conditions at home and abroad. People have excessive faith in markets, even if in circumstances they may be narrow, or manipulated or they may react to specific pressures which are not going to last. And secondly because governments have been, the general, reluctant in recognizing the need for adjusting the official rate, when it was necessary, because they fear the social and political consequences of a devaluation.

(2) Export penalty rate have to consider

(a) Demand elasticities are lower in the short than in the long run, and (b) income elasticities may be important and if there is a growing demand for a basic product, the country imposing the penalty rate may loose the opportunity of expanding its share in the foreign markets, especially if it is a low cost producer, due to the penalty rate. In this case some other form of taxation will be preferable.

In Chile, increasing taxation, on copper costs of production through the exchange rate, raised the share of foreign exchange to the domestic economy (see table A). The companies resorted to technological changes implying less use of labor and more imported capital. Furthermore, the penalty rate induced companies to purchase greater quantities of their operating inputs abroad, preventing exports of the Chilean economy to the foreign owned enterprises.

Despite the fact that Chilean cost of production was and is lower than of any other producer, the share of Chile in world production declined since the beginning of the 40's to a decade later (see table B).

New agreements were reached between the Chilean Government and the companies calling for different forms of taxation, new investments, enlargement of the production capacity and more control of Chile on the operations of the companies. Those changes took place in the middle 50' and 60's. Finally, at the beginning of the 70's the large copper mines belonging to American companies were nationalized and to-day they belong to the State.

Table 1

Percentage of copper sales abroad disbursed by foreign companies in Chile

Average	%
1940-41	47
1949-52	74

Source: ECLA

Table 2

Percentage of Chile in the World Production of Copper

Average	%
1940-41	18.6
1950-53	16.0

Source: U.N. Statistical Yearbook 1954. New York

(3) Subsidy import rate

They have two important disadvantages: (a) Subsidy is given equally to the poor and the rich and (b) if the country has the possibilities to develop the subsidized industries, the import rate may prevent of retard its establishment.

The effects of a devaluation on the poorest sectors of the population can be remedied by other social measures and so the subsidy import rate could be maintained only as long as the other measures are put in place.

(4) Spread between the buying and selling rates

This measures creates revenues for the government but it is protective and tens to reduce the volume of trade. It also has the disadvantage that unless transactions are well controlled, a market inside the margin can appear to avoid the tax.

PART II: DIFFERENTIAL INTEREST RATES POLICY (DIRP) WITHIN THE AFRICAN ALTERNATIVE AAF-SAP

I. INTRODUCTION

African countries are facing difficult problems and in order to solve them have approved an alternative framework for structural adjustment programmes for socio-economic recovery and transformation (AAF-SAP). To operationalize this program the E.C.A. has requested to some experts to write papers, which will examine policy instruments which have been selected by the authors of the program among them, the Differential Interest Rate Policy (DIRP).

This policy has been selected because IMF and World Bank stabilization and structural adjustment programmes require as one of its objective for developing countries to have market interest rates and if managed to have positive real rates, capable to mobilize internal savings and avoid the flight of them into foreign developed countries.

This paper will address to this problem and discuss the theoretical foundations of that position, what has been the experience of other countries, mainly in Latin America, and a sensible course of action which African countries may take on that matter.

II. THEORETICAL CONSIDERATIONS

1. Differentiated interest rates in free markets economies

It is well known that there is not one single interest rate in a free market economy. There are different rates, corresponding to the class of debtors, to the maturity of loans, to grace periods and form of payments of principal and interest. The interest rate is a complex variable whose level has to be explained by many factors; some of them "real", like the time preference of consumers and the productivity of capital and new investments; some of them "financial", which are generally affected by Central Bank Policy in order to reach its objectives of price stability, employment of all factors balance of payments equilibrium and acceptable economic growth. Furthermore, nominal interest rates are influenced by inflation expectations and expectations also affect the rate of savings (expected income) and the efficiency of investments (expected prices of inputs and outputs, expected position of markets at home and abroad, expected policies of national and foreign governments).

So many factors make impossible to explain why interest rates (and here I am referring to some basic rates, as let's say the "prime rate" in the US) in the last couple of decades has passed through periods in which the short real rates were nil or negative and some other times have reached levels so high that endangered many productive activities in developed countries and increased outrageously the foreign debt service of developing ones. (see table 1).

Our point here is that there is no good economic foundation to determine what the level of interest rates should be; and free market determination can lead sometimes to much higher or to much lower levels, both of which will entail problems to countries following that policy.

TABLE 1

US NOMINAL AND REAL INTEREST RATES 1974 - 1984

Years	Prime or Treasury bill rate	1/ n	Real Short term rates
1974	7,9	8,9	-1,0
1975	5.8	10,2	-4,4
1976	5,0	3,7	1,3
1977	5,3	10,7	-5,4
1978	7,2	6,7	0,5
1979	12,7	9,4	3,3
1980	15,3	8,6	6,7
1981	18,9	9,2	9,7
1982	14.9	6,6	8,3
1983	10,8	3,4	7,4
1984	12,0	4,4	7,6

1/ Inflation measured by the GNP deflector or by CPI.
Source: IMF, I.F.S. Several issues.

From the table, it can be seen that in a decade, short term real rates in the United States underwent enormous fluctuations with a range of 15 percentage points in the period.

In Chile from 1975 to 1981, bank rates were freed, with arguments very similar to the ones exposed by the international institutions.

The real rates on advanced heights of 38 and 35 per cent in 1977 and 1978. Only speculative and very short term activies like importation of luxuries could afford those rates. In 1979, and 1980 with the elimination of most controls over foreign borrowing,

they were reduced to 15 and 12 per cent, but by the suspension of foreign lending they reached in 1981 and 1982 the same levels as they had before (see table 3).

It has not been empirically established, that higher interest rates raise savings for investment. In the case of Chile, for example (see table 2) financial savings increased (column 3 of the table), but national savings went down dramatically, with a lesser decline also in gross investments.

TABLE 2

CHILE: AHORRO NACIONAL BRUTO, AHORRO EXTERNO 1/
Y SECTOR FINANCIERO
(% del PNB) 1974, 1978, 1981.

Años	A.N.B.	A.E.	Sector Financiero 2/
1974	25.3	6.8	12.0
1978	21.6	4.8	12.7
1981	11.3	12.6	25.9

1/ Déficit cuenta corriente de la balanza de pagos
2/ Agregado de instituciones financieras, seguro, propiedades inmobiliarias y servicios directos a las empresas.

FUENTE: José Ramos, Auge y caida de los mercados de capitales en Chile, datos de CEPAL y Banco Central de Chile

TABLE 3

CHILE: TASAS DE INTERES REALES1/ POR AÑOS
(Porcentajes) 1977-82

	Colocación	Captación
1977	33.1	5.2
1978	35.1	18.7
1979	16.4	9.4
1980	12.0	4.7
1981	18.7	28.6
1982	15.1	22.5

FUENTE: José Ramos, Auge y caida de los mercados de capitales en Chile.
Datos: Banco Central de Chile y F.M.I. I.F.S

In the requirement of international organizations about interest rate policies as in some other requirements as well, there is an element of belief about the superiority of free market determination of economic variables as opposed to government direction or intervention. Those are very valid alternatives because they represent points of views widely held by many economists and political scientists.

This is not the place to enter more deeply in this debate, but without ignoring the importance the market has for many or most economic decisions, even in developing economies, as the main arguments of this paper show, it is necessary to recognize that the mere fact of discussing economic development or recognizing the need of an economic development policy, by itself, is a proof that the market forces are not sufficient to produce the basic changes to obtain a society where all basic needs of the population are covered. Therefore we cannot accept market criteria when we have grounds -and sometimes proof- that they are not sufficient as a policy guide in developing economies.

2. Selective credit control to combat inflation

Selective credit control has been established in many countries, particularly in Latin America, to offset harmful effects of inflation, specially excessive investments in stocks, foreign exchange and land.

May be, it was hoped that selective credit control will allow the country to reach higher rates of savings and investments, without distortions in the assignment of productive resources and without serious balance of payments difficulties. The need for a general credit restriction will disappear as soon as the undesirable credit is eliminated.

It has to be kept in mind that all attempts to prescribe the purposes for which credit can be used will be useless as long as credit is plentiful for desirable objectives.

Neither the curtailment of undesirable investments, due to credit restrictions in certain directions, will lead automatically released resources towards more productive [illegible].

A period of inflation, specially if it has lasted some time, will probably not created an appropriated atmosphere for those productive investments to take place. In such a case, selective credit controls will reduce the level of expenditures and the rhythm of inflation.

But if this is the result which the authorities desired to attain, a better way to do it would be through general credit

controls.

On the other hand, selective controls could be used to prevent a runaway inflation. For example, if a large budget deficit or a surplus in the balance of payments cannot be prevented, a secondary expansion of bank credit could be mitigated with selective measures. But even with a mild inflation, if it is probably that it will be concentrated in some areas (for exarple, imports), then selective controls may be good substitutes for a general restriction on credit.

Another case where measures of selective control can be useful is when the country is engaged in a stabilization programme to stop or to reduce an inflationary process which is deemed excessive. If credit restrictions are one tool to reach this objective and the measures are strong enough, desirable and undesirable activities may be equally affected; and perhaps essential or basic activities will be more affected than others. In this case it appears reasonable to relax restrictions for basic or essential activities in order to avoid the reduction of them.

3. Selective credit control as a development policy

One important exponent of theoretical aspects of credit controls, or better selective credit controls, Omotunde E.G. Johnson[1] states that "many central bankers and others have noted with grave concern the fact that, to a large extent, commercial banks have allocated a supposedly disproportionate share of their funds to certain "traditional" activities. In particular, the banks have concentrated heavily on short-term, self-liquidating loans to finance foreign and domestic commerce. Medium-and-long-term loans, specially for the finance of industry and agriculture, have largely been neglected... the facilities of these banks tend to be available mainly -sometimes only- to established concerns in the urban areas. this generally means that concerns owned and managed by indigenous groups or individuals have been neglected.

According to this view, "the imbalance in the allocation of commercial bank funds has produced and threatens to perpetuate, an imbalance in the pattern of development of these countries". In order to divert the flow of funds from "low-priority" to "high-priority" areas, credit-control policies have been urged.

Johnson concludes that credit controls are attempts to equate private and social profitability as a tax-cum-subsidy schemes, and concludes that there is no logical basis for them. Instead, other

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[1] Paper on credit controls in Journal of Money, Credit, and Banking, February 1971.

kind of policies can be introduced that will not only achieve the desired goals sought by credit controls, but will do so more effectively and efficiently.

Johnson's paper is not a critique of credit controls as short-term policies to control credit in times of inflation or other emergency conditions (e.g. wars, drought). Instead he is against credit controls "as instruments of development policy". In the discussion contained in the paper he states that there are externalities connected with the "high priority" sectors demand for bank credit for two reasons. Financial institutions (including banks) underestimate credit worthiness and overestimate the risk, administration and collection costs associated with extending loans to certain sectors or have costs higher than the true social cost. In the second place, the commercial banks do not take into consideration the external benefits which expansion in the "high priority" sectors will yield for the rest of the economy.

In the first case, the effective demand of these sectors for resources including bank credit is low because, in their productive activity, they are "unable" to capture profitably the full value created by their activities, and the noninternalized position of this value is significant enough to warrant much use of society's resources in these activities. In the second case, banks underestimate the true effective demand of these sectors for bank credit, because banks are unable in estimating the effective demand.

If the issue is put in this form, the first case, in the opinion of Johnson, calls for a tax-cum subsidy, because is the whole society that captures the positive externalities flowing from the "high-priority" area. In the second case, what is wanted are institutions with supposed comparative advantage in assessing credit worthiness and in administering and servicing loans to the sectors considered "high privity sectors".

Before Johnson, in 1957, Javier Marquez[1] had expressed that "if authorities wish to favor certain activities or groups with access to funds which these activities or groups cannot ordinarily obtain from private financial institutions, the most expedient and clear-cut solution is the creation of official financial institutions which will undertake this financing". Marquez did not conduct his discussion in terms of cost-benefit analysis and his views were criticized by many participants in the meeting,

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[1] Director of the Center of Latin American Monetary Studies. Paper entitled "Financial Institutions and Economic Development", presented to a meeting on Latin America of the International Economic Association, Rio 1957.

especially, Professor Teixeira Vieira (University of Sao Paulo), Professor Brahmanda (University of Bombay), from India and Professor Wallich at the time Professor in Yale University and later in the Federal Reserve Board of the United States.

At the end of 1975, Deena Khatkhate and Delano P. Villanueva, from the Central Banking Service of the International Monetary Fund, prepared a paper on selective credit controls in less developed countries, which takes a contrary view to Marquez and Johnson's paper, specially the second one conducted in terms of cost-benefit analyzes. The authors review more than 57 papers on the subject and in the conclusions express: "Although these policies" (selective credit controls) are being used more and more in developed countries, when they consider that the impact of an aggregative monetary policy over investment and consumption is differential, the recourse to selective credit policies is imperative for less developed economies, where development assumes a total change in economic relations and furthermore, main goals of economic policy have become income distribution and greater employment through the use of less capital intensive techniques of production.

Almost at the same time (1975) Gustavo Petricciolí[1] former Director of the Bank of Mexico and Secretary of the Treasury of the same country, gives solid foundations to selective credit policies and describes the experiences of Mexico on the subject. He says: "Market mechanism, specially in developing countries with insufficient integrated economies, not always channels resources to activities of the highest economic and social priority. This is due also, among other reasons, to the numerous obstacles of drivers nature to mobilize real and financial resources in the adequate moment. Equally, there are highly speculative activities of low social benefits which distort capital currents. On the other hand exaggerated traditionalist attitudes of some entrepreneurs and financial intermediaries, due to lack of adequate information, prevent them to perceive "true" expectatives in the short and the long run of new fields of investments and induce them to operate in the short run, with "real" guaranties in the urban centers and with persons and groups they consider traditionally secure.

In the case of Mexico this problem is increased due to the complex structure of its geography which makes difficult the penetration of progress in relatively backwards regions.

In order to direct resources to high priority sectors, the

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[1] "Política e instrumentos de orientacionon selectiva del crédito en México", publicado por el Banco de México en un libro titulado "50 anos de Banco Central(1925-1975".

most powerful tool is fiscal policy, but monetary and credit policies can play also an important role.

Justification for government intervention in assigning the credit of the financial institution rests on the discrepancies between social and private benefits, as a consequence of market imperfections in developing countries. These discrepancies show themselves in (a) Subestimation about the credit capacity and the real possibilities of profitability and security of some projects in the priority sectors; (b) the existence of external economies. Credits to priority sectors may have multiplier effects, which cannot be absorbed by financial institutions and sometimes not even the users of credit can do it; (c) there is a lack of technology in certain sectors to generate and integrate productive projects which can be submitted to the banking system for its financing.

Technical assistance to small entrepreneurs and farmers can make more productive the financial resources.

There are a number of limitations of selective credit control policies. They may divide too strongly in sectors the economy and raise excessively the general interest rate, if the increase in resources to "nigh priority" sectors, reduces credit to the rest of the economy. If the banking system attempts to keep the same amount of credit to the "low priority" sector, it may create or aggravate inflationary pressures. It may also create black markets of credit or reduce the profitability of banking institution in an undesired amount.

Important problems are also to be sure that credit is utilized for the purposes stated in the regulations. Furthermore it is necessary to assess the effectiveness of the selective measures in changing or affecting the real economy.

4. Techniques of credit control

(a) Moral suasion. This may be very effective if the Central Bank enjoys a strong moral position in the financial community or if it has instruments or operations which it may eventually use or not use and which will make any financial institutions reluctant of not following advice of the monetary authority.

(b) Direct controls over types of loans, amounts, terms, guarantees, interest rates. These controls may be accompanied with sanctions. Direct controls present more administrative problems to the authorities.

(c) Indirect controls through rediscount of certain operations, according to the categories which the authorities wish to privilege.

(d) Government guaranties or rediscount facilities for operations having maturities longer than the banks are willing to take.

(e) Joint credits of official development institutes and banks, the latter receiving repayments during the first year of the first two years.

(f) To raise the normal reserve requirements and to allow the credit institution to comply with the additional requirements acquiring certain assets or making certain kind of loans.

(g) Legal reserve requirements are generally imposed on bank liabilities. But there is not impediment for establishing them on components of the asset side to the balance sheet. If the requirements are differentiated according to the type of asset, the authorities are trying to induce a certain composition of the bank portfolio. It is not known to the author that this technique has been used in any country.

(h) A combination of the above mentioned techniques.

III. EMPIRICAL EVIDENCE IN SOME COUNTRIES OF LATIN AMERICA

In this part we are going to discuss some measures and experiences of three countries in Latin America namely, Mexico, Chile and Ecuador. Those are countries located in different places of the Continent with economies highly different. The inclusion of some other cases which partly is not made due to the limitation of time, will not add much to the knowledge of the problems, because most of the countries have pursued similar policies, to a large extent imitated from one country to the other.

1. MEXICO[14]

In this country, there are two main financial mechanisms to direct resources to "high priority" activities. One is a great number of institutions created by the government in order to facilitate the financing of different economic sectors. Its resources are made up of domestic and foreign loans or deposits and some budgetary contributions. There is a National Bank of Rural Credit; National Financiera, which is the main development bank of the Government, the National Bank of Foreign Trade and the National Bank of Public Works and Services.

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[14] This part follows the explanation of Petriccioli's paper, already quoted.

The second mechanism is the selective orientation of credit, headed and regulated by the Banco de México (Central Bank). this has utilized two types of mechanisms. One is a regulation of general credit conditions (amounts, interest rates, maturities and guaranties) and its assignment to selected activities and regions. Main instrument of control has been the compulsory reserve (encaje) which banks and other financial institutions have to maintain against their liabilities.

Main orientation of resources has been directed towards.

(a) Financial public investments in infrastructure.

(b) Support exports, mainly of manufactured and semi-manufactured goods and tourism.

(c) Sectors generating employment and improving productivity.

(d) Housing for low income groups.

(e) Expansion of medium and small industry.

(f) Promotion of markets for industrial financial paper.

(g) Development of human resources.

According to the Banking Law, total bank liabilities, without counting operations which the Banco de México declares exempted. Should be kept as assets of the institutions, according to the following rules:

(a) Up to 50% in deposits in the Bank of México, which can utilized them in sectors of "high priority".

(b) Up to 25% in assets determined by the Bank of México, according to its policy of selective control.

(c) 25% in other assets, according to the law.

Reserves deposited in the Bank of México (50% of non exempted liabilities) can be raised up to 100% but only applicable to the <u>increase</u> in liabilities since the date the measure is adopted.

Another compulsory reserve worth mentioning is one over deposits in foreign currency captured by banks located near the border with the U.S. Those funds were channeled to finance exports and tourism facilities.

In general, credit given against compulsory reserves are directed to the activities which are predominant in the place where

the banks are located (agriculture in rural areas, industry in the urban centers).

Mexico has also established a system of Financial Development Fiduciary Funds, which operate at second floor banks, direct financial resources towards activities and regions which the authorities want to develop, through a rediscount policy of paper at preferential interest rates. But the main importance of these Funds is that they attempt to break bottlenecks which have limited development in certain sectors or regions. They provide technical assistance, guarantees and etc., several facilities.

Administration of Fiduciary Funds is in the hands of the Bank of Mexico (Central Bank) and National Financiera (main official development bank). Although some operations could be carried out by the administering institutions themselves, the creation of the Fiduciary Funds gives more room flexibility to operate and in some cases allow them to surpass some legal or institutional obstacles.

The system of fiduciary funds allows an evaluation of projects considering not only economic, but also social and technical aspects of them. The Funds, furthermore, can combine budgetary contributions with external and internal resources, tailoring its financing as far as amounts, interest rates, maturity of loans to the needs of the projects. The Funds provide also technical assistance for the formulation and evaluation of projects to be financed.

Fiduciary funds operate at preferential interest rates which are determined by the Finance Secretary and the Bank of Mexico according to interest rates prevailing in international market and the domestic situation. There are many Fiduciary Funds, but six are the most important. A summary is given about each of them.

(1) Fund instituted by the Federal Government in the Bank of Mexico in relation to agriculture (FIRA). Purpose is to increase food supply, to promote export programmes, to substitute agricultural imports and promote regional development. FIRA established in 1972 as the Fund to quickly to private bank up to 80% credits given to agriculture.

Studies made show that agriculture and livestock production increased the same as investment and income of farmers. In 1974 FIRA financed about US$1.0 billion (about 1/3 of that year).

(2) Fund to promote exports of manufactures (FOMEX)

This was created in the Bank of Mexico in order to give to the national exporter competitive conditions as far as costs and other financial conditions and also in order to reduce financial cost

during the pre-export period.

Furthermore an Insurance Company of Export Credit was created and since 1970 Mexican exporters enjoy facilities similar to the exporters of developed countries.

In 13 years FOMEX financed 74% of manufacturing exports.

(3) Fiduciary Fund of Industrial Development (FONEI)

It was established in the Bank of Mexico to modernize and to enlarge the country's industrial plant. It finances also projects to establish the technical, economic and financial viability of the projects. If the realization of the project is recommended, the cost of the studies are added to the total long run financing. If the recommendation is against the project FONEI can absorb part of the costs. FONEI finances purchases of goods and services abroad, provided that the operation has a net benefit for the balance of payments.

(4) Fiduciary Fund for Housing (FOVI)

This Fund also established in the Bank of Mexico to promote the construction of houses of social interest. FOVI channels resources of the private banks and also from the budget. In six years before 1975 FOVI participated in the construction of 121.000 houses of social interest with a total investment of around US$ 800 million of that time.

(5) Fiduciary Fund for Tourism (FONATUR)

This was established from the merge of two previous Funds run by the Banco de México and Nacional Financiera. The importance of this Fund arises from the fact that tourism was at the time the main activity producing foreign exchange in México. This Fund with the assistance of the Interamerican Development Bank contributed to the establishment of the Tourist complex of Cancún of world wide renown.

Other Fiduciary Funds worth to mention are one for fostering medium and small industries and another for development of human resources (Educative credit).

According to Perricholi, selective credit has contributed to overcome difficulties of some sectors to have access to institutionalized credit and banks have gradually participated in promoting activities in more backward areas.

The control of the Bank of México has been crucial, but this institution has been careful to preserve the profitability and

development of financial institutions in determining special rates of interest. Fiduciary Funds have helped to enhance effectiveness of selective credit control by means of providing additional funds, technical assistance and guaranties.

Notwithstanding the success indicated, the whole effort has been insufficient to cover all priority regions and activities. For the financing of a more balanced development, it is necessary to generate more savings and to put in practice new and bolder financial mechanisms.

2. ECUADOR[1]

In addition to the Central Bank, established in 1927, Ecuador has several private banks (over 20 nationals and 4 branches of foreign banks). Since the beginning of the oil era (1973) all these institutions benefitted from the growth of the economy and its external sector and contributed with their guaranty to the obtention of foreign credits.

It exists an official Bank called Banco Nacional de Fomento (National Development Bank) having branches and agencies practically over all the territory even on regions where banking activities are not profitable for private institutions. This Bank addresses mainly to the needs of agriculture and small industries and handicrafts. It operates at slightly more favourable terms than the private banks and its loans are of longer maturity, even if it is not an investment bank.

With great revenues received by the government from oil, more resources and Central Bank Credit was allocated to the Banco Nacional de Fomento and its net assets increased by 6 times since 1972 to 1976, but thereafter they have kept its nominal value, although inflation up to 1979 was at the rate of near 12% per annum.

It is worthwhile to mention the National Finance Corporation which was created as an imitation of the Mexican Nacional Financiera. It is government owned and its main objective is to provide credit (medium and long term) to industry. Since 1976 most of their loans go to the private sector. Financing of the Corporation is obtained, apart from its official Capital, from the issue of medium and long term bonds and credits from foreign financial institutions. This Corporation was established in order to provide mainly investment funds as banks traditionally preferred

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[1] This section is based on papers written by the author, who was 5 years advisor to the Central Bank of Ecuador (1974-78; 1983-84).

short term financing.

There is also an Ecuadorian Housing Bank, established to finance house construction to sectors with medium income levels; also should be mentioned the Bank of Cooperatives to promote and finance the establishment of Cooperatives in the country.

Several financial institutions of private character, like Mutualistas to finance housing and COFIEC, similar to the National Finance Corporation to finance industry but owned privately were in operations. Other private financial institutions started in the late 70's. All of them obtained financial resources from the Central Bank and abroad.

In the early 70's the Central Bank established a credit mechanism called Fondos Financieros, in order to channel through the banking system resources coming from external loans and at the same time compel the credit institutions to allocate part of its resources to development credits. On its side, the Central Bank granted rediscounts facilities of those credits to the promotion of agriculture, livestock production and industry.

National and foreign banks had to devote 20 and 25 per cent of their commercial portfolio to loans within this mechanism. Those institution not complying with this regulation have to buy Central Bank development bonds carrying a 4% of annual interest (inflation at the time was 10-12% per annum). They can be repurchased by the Central Bank when banks are complying with their obligation.

Central Bank rediscounts credits granted within the mechanism of Fondos Financieros in proportions from 80 to 100 per cent, according to the class of refinanced operation. For this purpose the Bank utilizes external credit given by the World Bank or the Agency or International Development (AID).

Credits within this mechanism are given at a rate of 9% collected at maturity and they are exempted of a tax of 1% on all other loans, therefore they had a high subsidy, considering that the ordinary cost of credit was near 15%. Rediscounts by the Central Bank are charged a rate of 3%, therefore banks have a margin of 6% on all operations.

By the end of 1978 total credit under Fondos Financieros were $4.800 million, which was near 30% of total bank credit at the date. Rediscounts reached to $2.486 million just about half of the credits granted: and only 12% of rediscounts had been made with foreign funds, the rest with Central Bank resources.

The mechanism during the first five years of existence

appeared to give a positive balance, specially in relation to agriculture and livestock production. Some criticisms have been also made too much bureaucratic and slow procedures, which are explained by the novelty of the system and the difficulties in starting it. Furthermore it was said that there was not a good control of the use of the credit and lack of technical assistance to the farmers using it. But making a global balance it would be difficult to deny the contribution made by Fondos Financieros to agricultural development, and specially to livestock production in Ecuador.

Foderuma (Fund for development of the rural marginal sector)

This Fund was instituted by the Central Bank with its own resources; later on, it was complemented with loans and grants from international organizations.

The credit is given mostly to indigenous communities (Andean communities existing from pre-hispanic times and preserving their customs, habits, language, beliefs, which may constitute 15-20-25 per cent of Ecuador's total population); it has special purposes, is highly subsidized and generally is under the control of some organization which takes responsibility of allocating the credit and supervising the tasks which have been assigned to different members of the community.

One community for example, was experimenting in building and making all they need (house, furniture, tools, clothing, food) using only local or indigenous raw materials. Another had started important enterprises in cheese production (even for export, as a food with high proteins). Development of handicrafts products which are highly attractive for tourists and some of them (even the U.S. market) was also a goal of FODERUMA.

Not all projects started were equally successful, but many of them were highly profitable. It could be said that when a religious institution (trusted by the indigenous) was in charge of the operation, chances of success were higher.

Despite the fact that recipient of FODERUMA credits were not subject of credit for ordinary bank credit and could not offer guarantees, Central Bank recovery of loans under FODERUMA was better than under other forms of lending.

After the crisis of Ecuador external dept 1982-83, the country had to enter in negotiations with the IMF. This institution requested establishment of interest rates positive in real terms and a simplification of the structure of rates. The only rate in existence in the years 1983-87 are given in the annexed table.

Ecuador: Annual interest rates in the domestic market, 1983-87
(% at the end of the period)
Dic. 83

Basic regulation Reg. 125-93

I. Legal interest rate
II. Maximum conventional interest rate
III. Central Bank operations
  (a) Public Sector and Foderuma[1]
  (b) Preferential discounts and rediscounts and National Development Bank Advances[2]
  (c) Specific discounts and rediscounts[3]
  (d) General discounts and rediscounts
  (e) General operations with external resources
  (f) General advances to banking and financial institutions

IV. Banks and Financial Institutions
  (a) Credits
    1. Fopex[4]
    2. Preferential operations[2]
    3. Specific operations[3]
    4. General operations with external resources
    5. General operations
      - Subject to Central Bank rediscounts
      - Other operations
  (b) Debits
    1. With fixed interest rates
      - Development Bonds
      - Public and private Bonds
    2. Free contracting
      - Savings
      - Time
      - Accumulation Policies[5]
      - Financial Certificates[5]

V. Surcharge for non payments

1. Special fund for financing agricultural marginal sector
2. These lines have been changing over time
3. Includes stabilization credits, popular housing, banking acceptances, National Development Bank credits, etc.
4. Operations created to raise funds from the public, since 1984 at free contacted rates

Source and elaboration: Central Bank of Ecuador

3. CHILE

As all other countries in Latin America Chile has made use of selective credit controls through specialized government institutions and since the 1950's through different Central Bank regulations. With them it was attempted to influence interest rates and other credit conditions of banks and financial institutions.

Already in the XIX century two State Banks were established. One called Caja de Crédito Hipotecario (Mortgage Bank) to finance long term loans for house construction and investments in agriculture. Interest rate was market determined, because the borrower had to sell in the stock market the caja bonds, but there was sometimes an intervention of the institution to facilitate the raising of new funds. The other was called Caja Nacional de Ahorros (Savings Bank). It was given a monopoly of savings deposits and later on, at the end of the 1950's also the monopoly of public sector deposits.

The Caja also acted as an ordinary commercial bank fulfilling operations of current accounts, short term commercial credit, foreign trade and exchange transactions, etc. etc.

The Central Bank of Chile was established in 1925, but it had mainly faculties of rediscounting to banks short term paper backed with operations of production and domestic and foreign trade. Although it had no faculties of credit control, neither could change the banks reserve requirements, it could fix the interest paid by banks for their time deposits, it could also make direct advances to the private sector (and did it at preferential interest rates) and lend with guaranty of agricultural products in order to obtain an orderly marketing of the main crops.

In the late 1920's, as a form of fostering the country's economic activities, some Government owned institutes were established: (a) Industrial Credit Institute (Instituto de Crédito Industrial); (b) Agricultural Credit Institute (Caja de Crédito Agrario) (c) Mining Credit Institute (Caja de Crédito Minero); (d) Mining and Industrial Development Institute of Tarapaca (Instituto de Fomento Industrial de Tarapaca); (e) Mining and Industrial Development Institute of Antofagasta (Instituto e Fomento Minero e Industrial de Antofagasta) and (f) Agricultural colonization Institute (Caja de Colonización Agrícola).

The first three were by far the most important in resource endowments. Their main function was to provide short and medium term loans to their respective branches of activity, specially to small producers. Loans were tailored to the needs of the users. Some of them were given in the form of inputs (like seed,

fertilizers, reconstruction capital to agriculture). The Mining Credit Institute acted also as purchaser of minerals to small producers in order to stabilize their prices.

The Agricultural Colonization Institute, provided with State capital, has the purpose of forming colonies and assisting the new farmers in putting their activities in touch mainly land offered to the Caja and some government-owned land. In total, its functions were rather limited until the middle 50's when an AGrarian Reform Law was enacted and a new institution called Corporation of the Agrarian Reform (CORA) with much larger resources and power replaced the CAJ.

A low cost housing institute (Caja de la Habitación Popular) was set up in 1936 with the purpose of providing new substitute by different state owned institutions which have tackled the problem of furnishing cheap dwellings to people of low monthly income. Even if something has been done by these institutes, there remains a tremendous task to fulfill and the main reason for this insufficiency has been the lack of funds. Of course the loans to the poor purposes have always had a high element of subsidy.

The most important of the state institutions in Chile to promote economic development is the Corporación de la Producción (Production Development Corporation) established in 1939. It was endowed with broad functions and large powers. It could lend to established enterprises, set up new ones, participate with other shareholders in new or existing ventures. It could give the State guaranty for domestic or foreign loans. The resources of the Corporación were budgetary allocations, foreign loans, which at the beginning were obtained from the U.S.A. Export-Import Bank and Inter Banking and Central Bank loans. Furthermore, the Corporation could sell all or part of the enterprises in its hands, thus replenishing its resources.

Many of the industries developed by the Corporation in Chile in the last 4 decades (electricity, oil, iron and steel, cellulose and newsprint, beet sugar and many others) have largely contributed to the country's needs for imports and some of them have become strong exporters.

The Corporación and all other institutes have had access to Central Bank rediscount mostly at preferential interest rates, and this credit has been pointed out as one of the factors of chilean inflationary process. Generally special laws have regulated those credits.

In the year last two important events took place in the financial field. It was established a State Bank (Banco del Estado) by a merger of the Caja Nacional de Ahorros (Savings Bank)

with the Caja de Crédito Hipotecario (Mortgage Bank), the Instituto de Crédito Industrial (Industrial Credit Institute) and the Caja de Crecito Agrario (Agricultural Credit Institute). All the functions and powers of the merged institutions were vested in the State Bank, which 5 years later was giving the monopoly of all public sector bank deposits. At the beginning of the 70's the State Bank had about half of all assets of Chile's banking system. Despite all efforts of the government after 1973 to reduce the role of the State Bank, it lost in relative size but increased its strength and it could weather better than any other financial institution the 1981-83 crisis and it is to be the most profitable one.

The other event was a complete revamping of the Central Bank law. Important for the purpose of this paper was the faculty of controlling not only the quantity of credit but also its quality. Furthermore, with the approval of the Bank Superintendent, the Central Bank could change the bank's reserve requirements and determine its form of compliance.

The first use of this new faculties in 1975 were directed to deny the banks the possibility of financing certain types of activities which the authorities deemed speculative and which were detracting funds from the country's basic production. Prohibited were the financing of the construction of apartment buildings in downtown Santiago, the purchase of automobiles and other goods, the acquisition of stocks in the stock market (incentive to speculation) and loans for consumption purposes (holidays, moving furniture or clothings, etc.).

In the following decades different criteria were put into force to finance certain agricultural inputs, exports (including preparation of goods for the export sector) and the sale of capital goods on long terms. But the exports amounts related to all this classes of financing were never very large in comparison with total bank financing.

One important measure as far as the magnitude of the credits involved was the establishment of a preferential rate to bank loans in the form of discounts, production [illegible] transportation, commerce and other services were excluded from this facility. The effective rate for the discount of promissory bills was slightly below the ordinary rate. This measure was approved because there was a big complaint on the part of producers due to a sudden elevation of the bank real interest rates. Inflation was drastically reduced between the end of 1975 and the year 1980, and

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[illegible] They were defined as having the signature of one person or society being a farmer, a miner or an industrialist.

nominal interest rates practically did not change. In order to alleviate the hardships of many entrepreneurs, the monetary authority set up the preferential rate for discounting "production" bills.

The techniques used by the Central Bank to enforce the different forms of selective credits were sometimes additional rediscounts or the faculty to the banks of counting preferred credits against reserve obligations. When quotas were imposed, violation involved penalties like the increment of cash reserves or non access at some types of Central Bank financing.

In the middle of the 1960's and for about a decade, the central Bank put into effect a credit system called "Linea crédito según presupuesto de caja" (Credit line according to a cash flow budget). For short, we shall call the system línea. It was an agreement between a bank or a group of banks to provide to an enterprise all its credit requirements, according to the norms established by the Central Bank and the Bank Superintendent. According to those norms the enterprise was obliged, as long as the agreement was in force, to make all his payments within 20 days and to deliver to the bank or banks all documents received for collection and to be put to the credit of the línea. On their side, the banks have to provide to the enterprise all the resources in the amounts and time determined by the cash budget.

In setting up the system, the Central Bank believed it was eliminating uncertainty about the credit reception to the producers: cash payments was going to imply avoiding higher costs for credit purchases. Lower costs should mean also lower prices and higher sales and profits. Executives, assured that they were going to have the credit they needed had more time to improve organization and productivity of their enterprises.

For the banks, the lína signified a better knowledge about the present and future financial position of their clients.

The maximum amount of the línea was determined by 6 months averages of some liabilities of the enterprise requesting the línea which were enumerated in the regulations. If the línea exceeded a certain amount it needed approval of the Central Bank, which therefore had a better knowledge and the possibility of controlling bank credit towards those activities which it had more interest in developing.

The linea system was obligatory for the banks. Starting at a certain date, a 4% of the total credit in the preceding month should be in the form of líneas and this percentage should have reached gradually a 20% after 1½ years. A 50% of the total credit given in líneas had to be in líneas below a certain amount, to

avoid concentration in a few large enterprises.

In operating the lineas, banks could use all the forms of credit which they utilized and there were no special interest or other conditions attached to the operations.

The Central Bank refinanced a part of the credit effectively granted in the form of lineas, according to a certain schedule. Refinancing was made through rediscount with an interest of 9% annual, and renewed, according to the linea requirements.

After a year, the linea could be renewed and in order to do it, enterprises having made improvements to its working capital, or having reduced prices in real terms or increased production, were supposed to obtain preferential treatment.

Lineas were praised and criticized. First from an ideological point of view because they implied too much intervention in private business. Then, because they had effectively the result of concentrating more the credit, notwithstanding the Central Bank efforts to prevent it. Banks had the feeling to have lost a great deal of manoeuvering because too many of their funds were tied up. On the positive side, it was mentioned that this form of credit allowed enterprises to improve its internal organization and to know better the results of its activity.

After 1973, lineas disappeared.

Bank general interest rates before the middle 1960's were market determined, but with some limitations. For every semester, the Bank Superintendent established what the average rate had been in the previous semester and no one (banks included) could charge as interest for a loan more than that average plus a 25% of it. due to the rather high inflation (about 30%) existing in Chile, during each semester rates tended to cluster near the maximum. There was then a tendency for rates to increase, sometimes staying at positive real values and sometimes near of below zero. It was shown before, that at a time of low inflation, real rates reached very high levels. Of course, special credits (like production bills, for example) had preferential rates. But the Bank attempted always not to be too far from the market.

At the end of the 60's a law was enacted empowering the Central Bank to determine all interest rates which were to be in force during each semester. In addition to the rate, the Bank could establish a variable tax which could reach up to 50% of the rate. The purpose of this scheme was to establish a positive real cost of credit for the user, but as a part of that cost was revenue for the government, bank profits did not increase so much when to raise the cost of credit was necessary. Of course, this measure

was creating a distortion, affecting the volume of financial savings and the optimum size of the financial system. It was not in force for a long time.

After 1975, rates of interest were freed and it was pointed out at the beginning of the paper the exorbitant levels they reached. After the collapse of the financial system and the bankruptcy and liquidation of many banks, the Central Bank started to suggest a rate for time deposits, which was in fact followed by all banks. Active rates are free, but competition among institutions prevent them to go too high.

All forms of selective credits through banks were abolished, except for the specialized institutions, which also were limited and reduced and for some lines given by institutions abroad with specified purposes and conditions.

Subsidies deemed necessary to be maintained (e.g. for low cost housing and for reforestation) were given directly through the budget. Central Bank does not lend neither to the government nor to banks but only operate with short term paper issued by itself in order to absorb or to expand liquidity to the financial system, thereby affecting the rate of interest, with the view of maintaining price stability, employment and balance of payments equilibrium.

In our view, present policies of the government of Child as far as the role of the Central Bank and the financial system, in contributing to the country's development, are exaggerated and represent a very unilateral and dogmatic position, which the facts themselves actually have determined some mitigating corrections.

On the other hand it would be naif to think that selective credit measures and differential interest rates can solve all or most of our problems. But they can provide a useful contribution to the expansion of some activities provided they are well studied, properly managed and within the limits of available resources.

In the case of Chile, for example, it would be difficult to deny the great role played by the Economic Development Corporation and the State Bank (with the credit institutions merged to it in 1953). Two criticisms made to them are valid. At a time, the Corporation engaged in too many ventures, some of which ended up as failures. And secondly, as financing was limited, they relied excessively on bank and particularly Central Bank credit for its operations. This was one factor, at times, of Chile's inflationary process, but it has to be recognized that it was not the only one.

IV. Drip in relation to AAF-SAP policies

(1) Specialized institutions

Development countries need to have official credit institutions to correct the lack of facilities of privates financial institutions or their bias towards short term commercial credit or international trade.

Longer term credit and financing of new sometimes risky ventures or to areas which are still in the beginning of development may offer social positive externalities which private parties are not in a position to capture. The may break also oligopolistic structures of the financial system or collusion between banks and enterprises, domestic and foreign.

Fiscal policy by means of tax incentives and well studied and reasonable subsidies can achieve a lot but this can prove to be not sufficient. A measure of selective credit, at more favourable than market conditions in indispensable. It is shown by the experience of all countries and it is confirmed by the proper lending policies of the international institutions and some other official credit institutions.

The I.M.F. was facilitating its resources at less than market interest rates. World Bank was financing and it is still financing specific projects on terms which borrowers cannot obtain from private source. I.D.A. a sister of the World Bank group was established to lend specifically at highly subsidized rates and longer periods to countries with such weak balance of payments which could nor afford commercial foreign loans. And the U.S. Agency for International Development (AID) was just established to make loans on soft terms.

Why countries cannot organized their domestic credit institutions in the same way?

Now, it is a matter of convenience to have one or several state credit institutions. My own inclination would be to have one but with different departments, operating with enough flexibility to satisfy the different branches of economic activity and the peculiarities of the country. The one institution can set up better priorities, can engage in different aspect of development (like project appraisal, raising of funds, administration, building occupancy) which means an economy as compared with having several institutions. Furthermore well trained personnel can be scarce in some African countries and this will call for one as compared with several institutions.

Development finance institutions have to put special emphasis on their activities being soundly financed (and consequently not inflationary) and that their resources are utilized where they can contribute the most to the sound development of the country. This requires good management, able and honest technicians and to disentangle those institutions as much as possible of political influence and the pressure of vested interest groups.

(2) Interest rates policies within the frame of AAF-SAP

We have seen with the examples of the United States and Chile that inflation affects interest rates in different forms. This happens when inflation is rising, but also when it is declining. This is due on the one hand to the fact that economic agents do not capture precisely the magnitude and direction of future inflation and sometimes it is also due to inconsistent policies on the part of the Central Bank.

In many developing countries fixed or slowly adjusting interest rates are usually unrealistically low and sometimes in negative rates. This fact is more accentuated with respect to deposit rates. It has been rightly said that this phenomenon brings about the following consequences.

- The process of financial intermediation is weakened, what is unfavorable, to the extent that this process helps the economy's development.

- Low real rates lead to inefficient productive processes. They lead to capital intensive as opposed to labor intensive projects (which are needed in countries with a large supply of labor). The lower the real rate of interest the more profitable are projects with a high ICOR (incremental capital-output ration): lower contribution to output of a given investment.

- There is a feeling of scarcity of bank credit, due to the excess demand for it. Managers of banks are in a position to ration credit according to their own priorities or according to the favors they want to make to some individuals and/or enterprises.

- If the country has a balance of payments deficit low rates tend to make the situation more serious, because there are incentives to transfer savings abroad. This is not the only reason for capital flights, but the lower the interest rate the more is this process incentivated.

International organizations are pressing countries to have

domestic real interest rates above the international rates or to leave them to be determined by the market forces. We have taken position against this last request, because in developing countries financial markets are too narrow, generally controlled by a small group of intermediaries which can easily manipulate them. On the other hand, if there is a productive sector with high indebtedness and very dependent on bank credit for remaining in business, this sector may be inclined to pay any interest rates even if they cannot be covered with the activities which the loan finances.

There is another problem in relation with nominal and real interest rate which may be relevant for some african countries. As in all macroeconomic considerations, in an inflationary environment it is assumed that all economic units are equal or behave like the average. Thus with a 10% annual inflation, it is believed that we have with a nominal interest rate of 15%, the same situation as with a nominal rate of 5% if inflation (or expected inflation) is zero. This is true on the average, and probably is true, when the country has an even inflation, repeating itself year after year at the same rate. But when we have a changing inflation (accelerating or decelerating) not all prices move at the same pace, some of them lead and some lag. Therefore the impact of adjusting interest rate to inflation may affect more some activities than others. This is even more true when at least part of the price increases are due to some extraordinary factor which may be reversed.

Interest rate policies deserve more attentive consideration when the productive sector of the economy is highly in debt, because then the level of the rates impinge more on the production costs and because excessive interest rates will force the government to grant special renegotiations or payments reductions in order to avoid generalized bankruptcies.

All the previous remarks do not invalidate what was said about the effects of too low or negative interest rates. But those assertions have to be taken with a grain of salt and the authorities must be alert to specific circumstances occurring in the economy at all times, observing in particular the side effects of the measures they are implementing.

We can put an example of a combination of fixed (but adjustable) bank interest rates with free rates which may meet the goal of keeping positive interest rates. We can have a small number of fixed rates, some of them containing a subsidy for limited purposes of high priority, and at the same time giving savers in financial institutions the possibility of obtaining a reward which will not incentivate them to transfer their savings abroad. Many similar schemes can be constructed. It is assumed that there is an inflation of 10% per annum. The rates are divided

between the Central Bank and the rest of the financial sector. Active rates are the ones charged by lenders, and passive rates are paid by banks and other financial institutions. The numbers in the table are nominal rates.

Central Bank	
Active rates	%
(1) Very special	12
(2) All other (including public sector and rediscounts	13
Passive rates	15
Banks and financial institutions	
Active rates	
- Preferential	15
- Generals	19
Passive rates	
- Short term time and savings deposits	15

Very special operations of the Central Bank and preferential of the principal institutions will be allocated for some very high priority activities, which can be effectively controlled and will be subject to quotas. Active generals it is assume to be the rate to be paid by general productive activities (to be defined).

In addition, financial institutions will be allowed to issue some liabilities (like 6 months or 1 year CD's)[1] which will carry market interests, according to the unsatisfied demand for credit at the above indicated fixed rates.

Fixed rates cannot be inalterable. They have to be revised each 3 or 6 months (perhaps sometimes more frequently) in order to put them in line with domestic inflation and the general condition of financial markets.

Free or market determined rates for the unsatisfied demand for

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[1] Most Central Bank liabilities do not pay interest, but it may be conceivable that the Central Bank issues some paper for stabilization purposes, for example.

credit have two dangers that the monetary authority should watch carefully:

(1) It may well be that on occasions (as it was the case of Chile, already quoted, after 1975) active rates go so high that they constitute a heavy burden for any activity. In that case the monetary authority can impose or even better to suggest,[18] a ceiling on them. This automatically limits the interest which financial institutions will be willing to pay for their free market liabilities.

(2) Also the margins between active and passive rates can get too wide. Then the monetary authority should decide what is a reasonable margin which makes financial intermediation profitable. If competition does not produce this margin, because there is collusion among the financial institutions, the authorities should fix a percentage over the passive rates which should the maximum they can charge for their active operations.

If in the country there is an organized market for stocks, bonds and other financial short or long term paper, public or private, an alternative to the free market loans and deposits within the banks could be the issue of private obligations with certain characteristics of values and maturities.

Banks could be allowed to guaranty that paper charging a commission to the issue. The borrower could sell that paper in the stock market at whatever discount it may fetch.

This imply a way of financing for the credit demanders which cannot be accommodated by the banks at existing fixed rates.

Another problem worrying international financial organizations is the one affecting medium and long term loans given to a country to be relent to entrepreneurs, specially when inflation rises and the interest rate becomes negative. This type of investment credit is convenient for any developing country due the lack of domestic medium and long term finance.

If there is a requirement of charging interest above a properly well defined rate of inflation it may be probably of interest to consider a scheme of interest capitalization which some World Bank officers occasionally have suggested. This scheme tends to make more even the real service of the loans during its life.

This can be illustrated with a simple example. One entrepreneur assumes a loan for an amount of 1000 pesos to be

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[18] This provided the suggestion is obeyed.

repaid in 5 annual equal installments. Nominal interest is 30 per cent per annum out of which 10 per cent is real interest and 20 per cent is the expected inflation rate (which in fact is realized). Let us see repayments (amortization and interest without and with interest capitalization).

End of year	Without capitalization			With capitalization				
	A[1]	i	Servicio=A+i	A[1]	i	Cap[2]	Debt balance[3]	Payment
1	200	300	500	200	100	200	1000	300
2	200	240	440	250	100	200	950	350
3	200	180	380	317	95	190	823	412
4	200	120	320	417	82	165	577	493
5	200	60	260	577	58	-	-	635

[1]Amortizations are the outstanding balances of the loan divided by the number of remaining years of life of the loan.

[2]Capitalization: Amount of interest exceeding 10% of the principal outstanding.

[3]Debt balance = Capital - Amortization + Interest capitalization.

In the following table we will compare present values of the flow of repayments of the loan without capitalization and with capitalization of that part of interest exceeding 10 per cent per annum. Present value has been calculated using the rate of inflation (20% per annum in this example)

Years	Present values of the flow of repayments	
	Without interest capitalization	with interest capitalization
1	417	250
2	306	243
3	220	238
4	155	238
5	104	235

Capitalization implies more even repayments -in real terms- during the life of the loan. In the first case total repayments add up to 1202; and in the second to 1224. The reason of that small difference is that in the first case amortization is more accelerated, because a part of the interest is amortization. Consequently, the sum of present value of interesrs is somewhat lower.